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BROKER DEALER

FINRA Proposes to Amend Rule 11892

On May 6, the Securities and Exchange Commission published a notice of filing of a proposed change to Financial Industry Regulatory Authority, Inc. Rule 11892 regarding clearly erroneous transactions in exchange-listed securities. The amendments grant FINRA the authority to declare null and void (i) transactions based on "fundamentally incorrect or grossly misinterpreted issuance information" and (ii) transactions that occur after a disruption or malfunction of the electronic communication or trading facilities or during a regulatory halt (i.e., a trading halt). The amendments allow FINRA to view a multiday series of trades as a single event if such transactions were based on fundamentally incorrect or grossly misinterpreted issuance information. FINRA's authority to declare such transactions null and void excludes transactions that have reached the settlement date or that are part of an initial public offering. The amendments also provide that each member firm involved in a transaction declared null and void or subject to a trading halt will be notified as soon as practicable.

The proposed rule change is available here.

SEC Approves FINRA Rule Change to Limit Self-Trading

On May 1, the Securities and Exchange Commission approved a change to Financial Industry Regulatory Authority, Inc. Rule 5210 regarding limits on self-trading. The amendments require FINRA member firms to establish policies and procedures reasonably designed to review their trading activity for, and to prevent, a pattern or practice of self-trades arising from a single algorithm or trading desk or related algorithms or trading desks. Self-trades are trades that do not involve a change in a security's beneficial ownership and that may be bona fide and unintentional. FINRA stated that the rule change would support its efforts to deter self-trading, which disrupts the marketplace, although such activity may not involve fraudulent or manipulative intent.

The order approving the rule change is available here.

PRIVATE INVESTMENT FUNDS

FATCA Transitional Relief and Extension of Time for the Implementation of New Account Procedures for Entity Investors

On May 2, the Internal Revenue Service issued a notice (Notice 2014-33) providing for a transition period for enforcing the withholding rules of the Foreign Account Tax Compliance Act (FATCA) and extending the period by which investment funds need to have FATCA procedures in place for entity investors. Pursuant to the notice:

- Years 2014 and 2015 will be regarded as a transition period for purposes of IRS enforcement and administration with respect to the implementation of FATCA; and
- With respect to entity investors, investment funds generally do not need to have their FATCA procedures for "new clients" in place prior to January 1, 2015. Such entity investors may be treated as existing investors for due diligence purposes. This extension does not apply to individual investors.

DIGITAL ASSETS AND VIRTUAL CURRENCIES

FEC Approves Bitcoin Political Donations While SEC Issues Investor Alert

On May 8, the Federal Election Commission (FEC) unanimously affirmed in an advisory opinion that political committees (including candidate campaigns and political action committees) could legally accept small bitcoin donations, acknowledging that digital currencies are a form of "money or anything of value" under election laws. While the advisory permits small bitcoin-denominated donations, it forbids bitcoin contributions in amounts greater than $100. The FEC also affirmed that a political committee could buy and sell bitcoins as an investment, provided that the political committee exchanged bitcoins for dollars prior to spending. The FEC declined to answer whether political committees could spend bitcoins on goods and services.

Meanwhile, on May 7, the Securities and Exchange Commission issued an Investor Alert highlighting the risks of investments relating directly or indirectly to Bitcoin. In particular, the SEC noted that Bitcoin early adopters and Bitcoin investment forums have been targets of fraudulent or high-risk investment schemes, some of which have involved bitcoin-denominated investments. The Investor Alert further noted that if investors become victims of fraud or theft involving bitcoin-denominated investments, they may have limited recourse for recovering the stolen bitcoins.

The Investor Alert listed the following issues that could hinder recovery options:

- Lack of involvement by traditional financial institutions (such as banks) impedes tracing the flow of money.
- International scope of transactions may restrict the SEC's ability to obtain information from abroad.
- No central authority collects Bitcoin user information, necessitating reliance on other sources for such information.
- Law enforcement may have difficulty seizing or freezing bitcoins.

The SEC also posited that risks inherent to the Bitcoin network and investments in bitcoins may pose risks to investments that are bitcoin-denominated or related to Bitcoin, even if investors do not invest directly in bitcoins. The SEC noted that proper disclosure of Bitcoin-related risks has been a problem area for certain non-fraudulent investments. The Investor Alert cited *SEC v. Shavers*, involving a Ponzi scheme denominated in bitcoins, as an example of Bitcoin-related fraud, and *In the Matter of Balanced Energy, LLC* along with the SEC's suspension of trading of Imogo Mobile Technologies securities as examples in which an issuer's disclosure of Bitcoin-related risks was insufficient.

With Bitcoin investments on the rise, and as Bitcoin continues to grow in popularity, the alert underscores the need to invest and conduct bitcoin transactions with companies and individuals that are well respected in the field.

The FEC opinion is available here.

The SEC Investor Alert is available here.

LITIGATION

SEC Charges Five Co-Conspirators in Reverse Merger Scheme

On May 5, the Securities and Exchange Commission brought charges in the US District Court for the District of New Jersey against a Toronto-based consultant and four associates for running a scheme to illegally reap millions in profits by taking two Chinese companies, China Auto Logistics Inc. and Guanwei Recycling Corp., public through reverse mergers with US public shell companies and then illegally manipulating and inflating the price of the stock.

According to the SEC's complaint, the scheme began in 2009, when S. Paul Kelley and his associates in the Kelley Group reached "secret oral agreements" with the management of China Auto and Guanwei that they would cover all of the companies' costs of going public in the United States in exchange for approximately 30 to 40 percent of the public companies' stocks. The defendants then acquired controlling interests in the stock of two publicly held US "shell" companies, which were used to conduct the reverse mergers with China Auto and Guanwei. They hid their control over the Chinese companies' stock through a vast network of US and international entities, sold shares in unregistered distributions and manipulated trading in the stock to inflate its price before dumping the shares.

Kelley agreed, along with co-conspirators Roger D. Lockhart and Robert S. Agriogianis, to settle the SEC's charges. In the settlements, Kelley agreed to pay $6,220,812 in disgorgement, prejudgment interest and penalties. Lockhart agreed to pay $3,152,268 in disgorgement, prejudgment interest and penalties, along with consenting to a bar from participation in any penny stock offering. In a cooperation agreement, Agriogianis also agreed to a penny stock bar and permanent injunctions. Notably, the three individuals were allowed to neither admit nor deny the charges, which is surprising given the scope of the conduct and the SEC's recent posture on settlements.

SEC v. S. Paul Kelley, et al., Civil Action No. 2:14-cv-2827 (D. N.J., May 5, 2014).

SEC Charges Investment Adviser with Custody Rule Violations

The Securities and Exchange Commission recently announced that it had charged Professional Investment Management, Inc. (PIM), an investment adviser, and its president, Douglas E. Cowgill, with violating rules governing the custody of client funds and overstating client assets by $753,535 for each of the last three months of 2013.

PIM manages approximately $120 million in assets for approximately 325 clients. The firm had custody of client assets through various securities and cash accounts, and therefore was required to comply with the "Custody Rule" under the Investment Advisers Act of 1940, requiring it to employ an independent public accountant who would conduct surprise examinations and to send clients quarterly account statements from a qualified custodian such as a bank or a broker dealer. The SEC has contended that PIM failed to arrange for independent verification of the funds from 2010 through 2013.

The SEC's complaint alleged that a shortfall of $753,535 in a money market fund account managed by PIM was discovered during its examination of the company. The complaint further alleged that Cowgill entered a fake sale in PIM's records in an attempt to cover up the shortfall in the money market fund and then later reversed the trade and disguised the transactions in client accounts. According to the SEC, Cowgill also allegedly provided additional falsified reports to the SEC and he later transferred funds from a cash account at another financial institution to try to eliminate the shortfall in the money market fund account.

US District Court Judge Algenon L. Marbley has issued a temporary restraining order against PIM and has frozen client assets following an SEC request for emergency relief for investors. Cowgill has asserted his right against self-incrimination in answering the SEC's complaint.

SEC v. Douglas E. Cowgill and Professional Investment Management, Inc., Civil Action No. 2:14 CV 396 (S.D. Ohio, May 5, 2014).

BANKING

FDIC Releases Resource Guide to Help Institutions Evaluate Opportunities with Community Development Financial Institutions

The Federal Deposit Insurance Corporation (FDIC) has produced a resource guide, Strategies for Community Banks to Develop Partnerships with Community Development Financial Institutions, to inform institutions of strategies to meet community credit and development needs and receive consideration under the Community Reinvestment Act (CRA) through collaboration with community development financial institutions (CDFIs). CDFIs are specialized financial institutions that provide products and services to underserved markets. Loans to and investments in qualifying CDFIs may help banks meet their CRA obligations.

The guide contains information to help community banks identify and evaluate opportunities to collaborate with CDFIs, and describes the key characteristics of CDFIs and the types of investments that can support them. It also discusses steps to consider when assessing bank/CDFI partnerships and how these activities may enhance CRA performance.

The guide can be downloaded from the FDIC's website.

FFIEC Member Agencies and State of New York to Focus Attention on Cybersecurity

On May 7, the Federal Financial Institutions Examination Council (FFIEC) highlighted regulatory efforts to enhance financial institutions' cybersecurity during a webinar for approximately 5,000 chief executive officers and senior managers from community financial institutions. The FFIEC has six voting representatives of member agencies including the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Board of the National Credit Union Administration, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau and the Chairman of the State Liaison Committee. The FFIEC offered this webinar "to raise awareness about the pervasiveness of cyber threats, discuss the role of executive leadership in managing these risks, and to share actions being taken by the FFIEC."

FFIEC announced a vulnerability and risk-mitigation assessment as well as a regulatory self-assessment of supervisory policies and processes. "These assessments will be conducted later this year and will help the FFIEC member agencies make informed decisions about the state of cybersecurity across community institutions and address gaps and prioritize necessary actions to strengthen supervisory programs. FFIEC members want to provide additional support to community banks, which may not have access to the resources available to larger institutions."

FFIEC highlighted key focus areas for senior management and boards of directors of community institutions as they assess their institutions' abilities to identify and mitigate cybersecurity risks, including:

- setting the tone from the top and building a security culture;
- identifying, measuring, mitigating and monitoring risks;
- developing risk management processes commensurate with the risks and complexity of the institutions;
- aligning cybersecurity strategy with business strategy and accounting for how risks will be managed both now and in the future;
- creating a governance process to ensure ongoing awareness and accountability; and
- ensuring timely reports to senior management that include meaningful information addressing the institution's vulnerability to cyber risks.

The basic materials utilized in the presentation from the webinar are available on the FFIEC website.

In related news, Gov. Andrew Cuomo announced on May 6 that he has asked the New York Department of Financial Services to conduct cybersecurity assessments of financial institutions to ensure that they are appropriately protecting sensitive customer data. State-chartered banks, credit unions and foreign banks whose US headquarters are in New York will all be subject to the examinations.

Read more.

CFPB Proposes Rule on Privacy Disclosures

On May 6, the Consumer Financial Protection Bureau (CFPB) proposed a rule that would allow institutions that limit their consumer data-sharing and meet other requirements to post their annual privacy notices online rather than delivering them individually.

"Consumers need clear information about how their personal information is being used by financial institutions," said CFPB Director Richard Cordray. "This proposal would make it easier for consumers to find and access privacy policies, while also making it cheaper for industry to provide disclosures."

The Gramm-Leach-Bliley Act (GLBA) generally requires that financial institutions send annual privacy notices to customers. These notices must describe whether and how the financial institution shares consumers' nonpublic personal information. If the institution does share this information with an unaffiliated third party, it typically must notify consumers of their right to opt out of the sharing and inform them of how to do so.

The proposal "would allow institutions to post privacy notices online instead of distributing an annual paper copy, if they satisfy certain conditions such as not sharing data in ways that would trigger consumers' opt-out rights. This proposal would apply to both banks and those nonbanks that are within the CFPB's jurisdiction under the GLBA. Institutions that choose to rely on this new method of delivering privacy notices would be required to use the model disclosure form developed by federal regulatory agencies in 2009." Under the proposal, if an institution qualified for and wants to rely on the online disclosure method, it would have to inform consumers annually about the availability of the disclosures. Currently institutions must send consumers a separate communication about privacy disclosures. Under this proposal they could include inserts in regular consumer communication, such as monthly billing statements for credit cards, letting consumers know that the annual privacy notice is available online and in paper by request at a toll-free telephone number. If an institution chose not to use the online disclosure method, it would need to continue to deliver annual privacy notices to its customers.

The CFPB will accept comments on the proposed rule for 30 days after its publication in the *Federal Register*.

A copy of the proposed rule is available here.

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