INVESTMENT MANAGEMENT LEGAL + REGULATORY UPDATE

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REGULATORY UPDATES

NEP Announces Never-Before-Examined Initiative

On February 20, 2014, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced that its National Exam Program (NEP) launched an initiative to "engage with" investment advisers that have never been examined by the SEC. NEP excluded from the initiative advisers to private funds that registered after the implementation of the Dodd-Frank Act and that are subject to the NEP's presence exam initiative.

The staff said that it will focus on advisers that have been registered three years or more, conducting risk assessments or focused reviews. The risk assessments generally will focus on an adviser's compliance program and "other essential documents" that will enable examiners to assess representations made in an adviser's disclosure documents, such as the Form ADV.

The focused review, which reflects the staff's 2014 examination priorities (see our related client alert), will be a comprehensive review of one or more of the following areas that the NEP staff considers to be "higher risk":

- *Compliance Program*. Compliance programs adopted by an adviser under Rule 206(4)-7 must be reasonably designed to prevent violations of the Investment Advisers Act. Among other things, the staff will assess whether an adviser has empowered a competent CCO to administer its compliance program.
- *Disclosure*. An adviser's filings and disclosure documents must contain all material facts regarding conflicts of interest so that clients can determine if they want to enter into or remain in an advisory relationship. The NEP staff will take a deep dive into advisers' disclosure documents.
- *Marketing*. The NEP staff will consider whether, among other things, an adviser's marketing materials include false or misleading statements about its business or its performance history. Advisers are reminded that Rule 206(4)-1 under the Advisers Act precludes an adviser from including in its advertisements any untrue statement of material facts or omitting material facts.
- *Portfolio Management*. The NEP staff may review and evaluate an adviser's portfolio decision-making practices. Specifically, this may include a review of allocations and whether the adviser is acting in a manner consistent with the disclosure it has given clients.

- *Custody.* The NEP will examine whether advisers that have custody of client assets are taking appropriate measures to protect such assets from loss or theft.

OCIE makes it clear that NEP may refer any deficiencies it finds to the SEC's Division of Enforcement or to state or other regulatory agencies for possible action.

In addition to the examination initiative, NEP also announced an outreach program for never-before examined advisers. The NEP staff will conduct regional meetings to help these advisers learn more about the examination process.

Examination Priorities for 2014

FINRA published its regulatory and examination priorities for 2014 (see our related client alert). This year's letter, published earlier in the year than before, includes many time-honored themes, such as conflicts of interest, complex products, suitability, AML, private placements, and algorithmic and high-frequency trading. It also addresses significant new topical issues, including qualified plan rollovers, crowdfunding, and recidivist brokers.

We anticipate that FINRA's 2014 examinations will focus as much on the quality of a broker-dealer's supervisory systems and procedures as on any underlying violations or customer harm. Indeed, Executive Vice President for Regulatory Operations, Susan Axelrod, who oversees the exam program, stated, "We encourage firms to use this guidance along with their own analysis to enhance their programs as we will be examining for strong controls and robust compliance efforts in these areas."

Following closely on the heels of the publication of FINRA's examination priorities for 2014, the NEP released a summary of its 2014 priorities. OCIE's priorities reflect the staff's assessment of information including:

- data from reports filed with the SEC;
- data gathered in the course of examinations;
- whistleblower tips;
- data retrieved from third-party databases;
- tips and communications from other regulators, including those outside the U.S.; and
- interactions with registrants, industry groups, and service providers outside of the examination process.

The summary includes market-wide priorities as well as examination focuses related to investment advisers/investment companies, broker-dealers, transfer agents and other market participants. Across the board, it is clear that, in 2014, the SEC examination staff will focus on conflicts of interest and registrants' controls designed to identify and mitigate such conflicts. Investment advisers should carefully evaluate their compliance programs in light of that focus to be certain that they have adopted compliance programs designed to ensure that transactions occur in the best interests of investors.

A summary of SEC examination priorities relevant to broker-dealers and investment advisers can be found in our client alert.

Division of Investment Management Lists 2013 Accomplishments; Sets 2014 Agenda

The SEC's Division of Investment Management summarized its activities in 2013, highlighting its intensified rulemaking program, efforts to identify new and emerging risks and its disclosure initiatives. The Division also took the opportunity to discuss its agenda for 2014.

In the March 2014 edition of its Information Update, the Division describes its rulemaking accomplishments in the past year, including proposed rules to reform regulation of money market funds; adoption of final rules implementing the Volcker Rule (along with the federal banking regulators); finalization of rules implementing the JOBS Act mandate to lift the ban on general solicitation and general advertising for certain private offerings; and issuance of guidelines to prevent identity theft.

The Division also noted the publication of its new guidance, and recounted its "enhanced dialog with the industry."

Looking ahead, the Division said that in 2014 it expects to:

- possibly adopt new fund disclosure rules;
- adopt final rules to implement the JOBS Act and the Dodd-Frank Act;
- finalize money market fund reform rules;
- determine next steps in the SEC's investment adviser/broker-dealer initiative; and
- enhance disclosures about variable annuities

Conspicuously absent from the list of priorities are mention of former front burner topics, including:

- guidance for valuation of portfolio securities;
- rule proposals for or guidance on investment company use of derivatives and leverage; and
- final rules to reform fund distribution ("Rule 12b-2").

These accomplishments and priorities, viewed in the context of the focus of recent and ongoing general and sweep examinations and resulting referrals to the Enforcement Division, may provide additional clues about staff's primary areas of focus.

Money Market Fund Reform Inches Forward

The staff of the SEC's Division of Economic and Risk Analysis (DERA) made available its analyses of data and academic literature relevant to pending money market fund reform. DERA said that the analyses could assist the public in "evaluating final rule amendments for the regulation of money market funds" and DERA encouraged comment on the analyses.

DERA published the following analyses:

- an analysis of the spread between same-day buy and sell transaction prices for Tier 1 and Tier 2 securities. The analysis documents changes in liquidity cost before, during and after the window between Lehman Brothers' bankruptcy and the Federal Reserve's announcement of the Money Market Investor Funding Facility;
- an analysis of the exposure of government money market funds to non-government assets during the period from November 2010 until November 2013;
- an analysis of municipal money market funds' use of the "25% basket," under which up to 25% of the value of such fund's portfolio may be subject to guarantees or demand features from a single guarantor; and
- a review of the availability of domestic government securities and global "safe assets."

The analyses do not, in and of themselves, move the pending rules forward. They do, however, demonstrate that the SEC continues to carefully consider available data in its decision-making process.

FinCen Issues Guidelines for Marijuana-Related Businesses

The Financial Crimes Enforcement Network (FinCEN) got a whiff of the fact that financial institutions provide services to burgeoning marijuana-related businesses and published guidance to clarify customer due diligence expectations and reporting requirements for financial institutions. Baked into the unusual guidance, dated February 14, 2014, is the government's tacit acknowledgment that financial institutions can provide services to these businesses, even though federal law prohibits their activities.

Background. The Controlled Substances Act (CSA) makes it illegal under federal law to manufacture, distribute or dispense marijuana. Despite the federal ban, 20 states and the District of Columbia have legalized varying levels of marijuana-related activity. Federal banking regulators now face an unusual dilemma: how can interactions of financial institutions – like banks, money services businesses, broker-dealers and investment companies – be legal with businesses that are illegal under federal law?

FinCEN writes the rules and regulations that financial institutions must follow to help protect the U.S. financial system from money laundering and terrorist financing. FinCEN implements the requirements of the Bank Secrecy Act (BSA), which is designed to help the federal government detect and prevent money laundering. Among other things, FinCEN regulations require financial institutions to file a "Suspicious Activity Report" (SAR) when it suspects that a transaction, or series of transactions, involves illicit financial activity.

BSA reporting requirements unaffected by state law. The guidance reminds financial institutions that their reporting obligations under the BSA with respect to financial transactions involving marijuana-related businesses continue, even though the activities are now legal under state law. The guidance clarifies how financial institutions can provide services to marijuana-related businesses in a manner consistent with their obligations under the BSA.

Reconciling conflicting laws. FinCEN reconciled the inconsistencies between state and federal law with respect to the legality of marijuana sales with a bit of smoke and mirrors. If a financial institution provides services to a business that does not implicate a set of enumerated priorities (for example, selling marijuana to a minor, or financing terrorist activities), the financial institution must file a "Marijuana Limited" SAR, containing limited information, even though the activity is legal under state law. If it suspects that the business is engaged in some of the enumerated "priority" activities, the financial institution must file a full SAR. The enumerated activities are contained in an August 29, 2013 guidance published by the Department of Justice to U.S. Attorneys regarding marijuana enforcement (popularly known as the so-called "Cole Memo").

FinCEN's apparent goal is to collect information on transactions with businesses that are legal under state law, and weed out transactions that are high on FinCEN's list of "priority" activities.

Our Take: Broker-dealers and investment companies that establish accounts with marijuana-related businesses should review their know-your-customer procedures to ensure that they comply with FinCEN's guidance. Broker-dealers and investment companies should conduct due diligence efforts. Among other things, financial institutions should:

- verify with state authorities that the business is properly licensed and registered;
- request from state licensing and enforcement authorities information about the business and related parties;
- understand the normal and expected activity for the business, including the types of products to be sold and the customers served (e.g., medical versus recreational customers);

- conduct ongoing monitoring of publicly available sources for adverse information about the business and related parties; and
- conduct ongoing monitoring for suspicious activity, including the red flags described in the guidance.

In any event, financial institutions should think twice before engaging in transactions with a marijuana-related business, which may violate federal law, even though the Department of Justice or a federal banking regulator, as a matter of policy, chooses not to prosecute.

Staff Roadmap for Alternative Investment Due Diligence Processes

The SEC staff believes that investment advisers, including pension consultants, are increasingly recommending that their clients invest a portion of their portfolios in private alternative investment funds. In light of that trend, the NEP staff published a Risk Alert addressing due diligence processes related to selecting alternative investments and their managers.

The NEP staff recognizes that due diligence of alternative investments can be more challenging in light of the characteristics and complexity of certain alternative strategies. The Risk Alert sheds some light on the staff's views of "best practices" for such due diligence and related compliance programs. Investment advisers might also glean some insight into the examination staff's focus in upcoming visits.

For more information, see our recent client alert.

NFA Requests Comments on Need for CPO/CTA Capital Requirements

In a Notice to Members, the NFA asked whether it should impose capital requirements on commodity pool operators (CPOs) and commodity trading advisors (CTAs). One issue that is likely to generate significant comments is that the NFA does not appear to distinguish advisers of registered investment companies that are required to register as CPOs under recently amended CFTC Rule 4.5.

The NFA's Notice, published January 23, 2014, also requests comments on other customer protection measures, including:

- requiring an independent third party to review and authorize a CPO's disbursement of any pool funds;
- requiring an independent third party to verify calculations related to the pool's performance; and
- requiring CPOs to periodically verify pool assets.

The Notice does avoid mention that regulations designed for traditional commodity pools often do not apply to investment companies that are also commodity pools. For example, Section 18 of the 1940 Act limits the ability of investment companies to leverage their portfolios, so the need for capital requirements does not necessarily apply to the same extent as it may for traditional commodity pools. Registered investment companies must also provide investors—and the SEC—with periodic audited financial statements, thus lessening the need for third-party verification of a fund's performance calculations and its assets.

The NFA can easily resolve these inconsistencies. It can adopt the concept of "substitute compliance" recently utilized by the CFTC with respect to disclosure and compliance obligations of registered investment companies that are also deemed to be commodity pools (for more information see our client alert). The Notice serves as a reminder, however, that registered funds and their advisers must be vigilant about other regulatory requirements that could inadvertently create land mines for funds.

Cybersecurity in the Regulatory Cross-hairs

After announcing that cybersecurity is one of its 2014 examination priorities, FINRA wasted no time before announcing a sweep examination to assess firms' approaches to managing cybersecurity threats.

FINRA said that its concern results from "the critical role information technology (IT) plays in the securities industry, the increasing threat to firms' IT systems from a variety of sources, and the potential harm to investors, firms, and the financial system as a whole that these threats pose." FINRA said that the sweep examination will look into cybersecurity areas including:

- approaches to information technology risk assessment;
- business continuity plans in case of a cyber attack;
- organizational structures and reporting lines;
- processes for sharing and obtaining information about cybersecurity threats;
- training programs; and
- contractual arrangements with third-party service providers.

FINRA isn't the only regulator focusing on cyber security. In January, a high-level SEC official told an industry group that the NEP will review asset managers' policies and procedures for preventing cyber attacks. In particular, the SEC is looking at the risks created by asset managers who give vendors access to their information technology systems.

As reported by Reuters, Jane Jarcho, national associate director of the SEC's Investment Adviser/Investment Company examination program, stated, "We will be looking to see what policies are in place to prevent, detect and respond to cyber-attacks."

Ms. Jarcho's statement about asset managers continues a theme recently articulated in the NEP's 2014 examination priorities. Among other things, NEP examiners will review firms' vendor due diligence procedures and ensure that asset managers report cyber intrusions to their regulators. It is safe to say that the SEC's examination program will also look at how broker-dealers maintain system security.

FINRA has already shown a willingness to pursue disciplinary action in this area – see our recent client alert – and firms should understand that FINRA or the SEC could take action based upon examination findings of deficient cybersecurity procedures.

Five Senators Slam OFR Asset Management and Financial Stability Report

In a letter dated January 23, 2014, five senators criticized the Office of Financial Research (OFR) study *Asset Management and Financial Stability*, alleging that the study contained "troubling errors" that call into question its legitimacy.

The OFR's controversial study, prepared at the request of the Financial Stability Oversight Council (FSOC), suggests that some asset management activities "could create vulnerabilities" that may justify designation of asset managers as systemically important financial institutions (SIFI).

"The OFR Study mischaracterizes the asset management industry and the risks asset managers pose, makes speculative assertions with little or no empirical evidence, and in some places, predicates claims on misused or faulty information," the senators wrote. They also cited a lack of transparency and accountability to explain the "alarming dearth of accurate data" and other information used to support the study's conclusions.

The senators argued that asset managers function primarily as agents that manage money as fiduciaries, subject to specific guidelines, and that the asset managers do not assume the financial risks themselves. It does not follow, the senators suggest, that advisers themselves would experience the type of financial distress that can affect banks and "proprietary risk-takers," let alone threaten the U.S. financial system.

The study also fails to appreciate the extensive existing regulation of investment management activities, the senators said.

The five senators who were signatories of the letter were Democrats Claire McCaskill of Missouri and Thomas Carper of Delaware, and Republicans Mark Kirk of Illinois, Patrick Toomey of Pennsylvania and Jerry Moran of Kansas.

SEC Staff Urges Bond Fund Advisers to Reassess Risk Management in Light of Market Volatility

In late January, the SEC's Division of Investment Management recommended that fixed income fund advisers take steps to assess portfolio risk in light of "potential market volatility" and review the adequacy of related prospectus disclosures.

In particular, the staff suggested that fund advisers consider taking the following steps:

- *Assess and stress-test liquidity* during normal and stressed environments, taking into account sources of liquidity over 1-day, 5-day, 30-day and possibly longer periods;
- *Conduct more general stress tests and scenario analysis* to assess how interest rate hikes, widening spreads and price shocks, increased market volatility and reduced liquidity affect portfolio values;
- *Conduct risk management evaluations* based on these assessments to determine appropriate risk management strategies and actions under the circumstances at a fund level and at a complex level;
- *Communicate with fund boards* so that they understand not only the risk exposures and liquidity position of the fund, but also the fund's ability to navigate changing interest rate conditions and market volatility; and
- *Review shareholder communications* to ensure that disclosures are adequate in light of any additional risks due to recent events in the fixed income market and the potential impact of tapering quantitative easing and/or rising interest rates, including the potential for periods of volatility and increased redemptions.

These recommendations come against a backdrop of what the staff characterized as "increased volatility" in the bond market during June 2013, as investors considered indications that the Federal Reserve Board would soon wean the markets away from its "quantitative easing" program, followed by a general rise in interest rates.

Retirement Funds Rollovers: FINRA Ends 2013 by Identifying Its First 2014 Priority

At the end of the year, when many people were thinking about the status of their retirement accounts and planning any changes to their investments, FINRA also had retirement accounts on the brain. In Regulatory Notice 13-45, FINRA noted that one of its examination priorities in 2014 will be reviewing firm practices when recommending a rollover of assets from an employer-sponsored retirement plan to an IRA.

According to FINRA, when a participant in an employer-sponsored 401(k) retirement plan changes employers, he or she has four options:

- leave the money where it is;
- roll the assets to the new employer's plan (if possible);
- roll the assets over to an IRA (by far the largest source of contributions to IRAs); or
- cash out the account, which could have tax penalties and unfavorable tax treatment if the employee is under 59½ years old.

When making this decision, many investors seek the advice of a financial advisor, who may be a registered representative of a broker-dealer. If a broker-dealer recommends that an investor roll over retirement plan assets to an IRA, or otherwise engages in marketing IRAs, it typically makes securities recommendations. These activities are subject to FINRA rules.

SEC Intensifies Scrutiny of Fee-Based Accounts and Reverse Churning

The SEC is crunching a lot of data these days, and apparently intends to use some of that data to identify "reverse churning." Reverse churning is the practice of placing a client who trades infrequently in a fee-based, rather than a commission-based, account; Chair Mary Jo White recently identified this as a problem that the SEC can detect through its quantitative analytics.

Based upon the SEC's and FINRA's past regulatory and enforcement focus in this area (see our recent client alert), we recommend that firms review their supervisory systems and procedures to ensure that they are adequate to identify possible instances of reverse churning before the regulators do.

ENFORCEMENT + LITIGATION

The SEC Speaks: Reflections and Enforcement Initiatives in 2013

Each year at The SEC Speaks, the Commissioners and senior leadership of the SEC identify the agency's priorities and initiatives for the coming year. One of the most anticipated discussions concerns the SEC's enforcement trends and priorities, and this year the Division of Enforcement's most senior staff members provided their thoughts on the past, present and future of their work. Though many recently-announced changes in personnel at the SEC are certainly a distraction from the Division's work, the staff made it clear that it intended to continue its aggressive enforcement program in 2013. You can read our Client Alert summarizing the announced initiatives by clicking here.

SEC Sanctions Adviser for Failing to Inform ERISA Clients of Improper Investment Allocation

The SEC recently sanctioned an investment adviser for allowing some of its ERISA plan clients to invest in private placements, even though the issuer specifically restricted investments by ERISA plans. The SEC found that the adviser violated its error correction policies by failing to immediately correct the breach.

Due to a coding error at the time of purchase, the adviser's compliance system classified the investment as ERISA eligible, when in fact it was not. Neither the portfolio compliance staff nor the trader recognized that the security was not eligible for ERISA accounts. In the following months, the adviser placed $90 million par value of the issue in 99 ERISA client accounts.

Upon learning of the error more than 18 months later, the adviser corrected the compliance coding fields from ERISA eligible to ERISA ineligible. After a three-month internal investigation, the adviser concluded that there were no guideline breaches and no "prohibited transactions," but that the adviser might have potential exposure to the issuer for breaching the terms of the offering. The adviser did not notify its ERISA clients of the improper allocation at this time, because it concluded that no breach of client guidelines had occurred.

More than two years after purchasing the securities, the adviser sold the entire position at prices materially lower than the purchase prices for all of its clients. The SEC found that before executing the sales, the adviser neither informed its ERISA clients that it had improperly allocated the security to their accounts, nor did it advise them of its coding error. More than one year later, after it was aware of the SEC investigation, the adviser notified its clients of the error.

The SEC found that the adviser violated the general anti-fraud provisions of the Investment Advisers Act of 1940. It also found that the adviser failed to adhere to its compliance policies and procedures adopted pursuant to Rule 206(4)-7 under the Advisers Act. The SEC noted that the adviser's compliance policies required the adviser to promptly notify its clients of any breaches or errors resulting in a loss, and to make clients whole for such losses. The SEC disagreed with the adviser's assertion that the adviser's narrow interpretation of its guidelines did not require such a notification.

Without admitting or denying the allegations, the adviser agreed to

- pay its affected ERISA clients compensation of approximately $9.6 million;
- hire an independent compliance consultant to conduct a comprehensive review of the adviser's supervisory and compliance policies and procedures designed to resolve allocation and coding errors;
- pay a $1 million civil fine; and
- receive a censure.

The case involved a complicated set of facts and demonstrates that the SEC examination staff will dig deep into the facts when it believes it has identified compliance violations. It also underscores a recurrent theme: the SEC takes seriously any failure to adhere to compliance policies. In this case, the adviser narrowly interpreted its compliance policies and procedures to conclude that no violation had occurred. The SEC disagreed, and effectively sanctioned the adviser for not taking a more expansive view of its compliance responsibilities.

CFTC Again Charges Civil Perjury – This Time for Statements Made in an Off-the-Record Interview

On January 2, 2014, the U.S. Commodity Futures Trading Commission (CFTC) ordered a Russian foreign national to pay a $250,000 civil penalty for making false and misleading statements to CFTC staff in an interview during an enforcement investigation. The CFTC issued the penalty pursuant to new authority under the Dodd-Frank Act, which amended the Commodity Exchange Act to make it unlawful for "any person to make any false or misleading statement of material fact to the Commission." Before Dodd-Frank, the CFTC had to rely on the Department of Justice to prosecute false statements made during investigations under general criminal statutes.

The Order's factual conclusion that the interviewee knowingly made false and misleading statements to CFTC staff during the interview is hardly remarkable. But the statements were made in a presumably *unsworn*, *untranscribed* interview. As previously discussed in the BD/IA Regulator, in September the CFTC penalized an individual for making false and misleading statements to CFTC staff in sworn testimony during an enforcement investigation, *In re Butterfield* (CFTC Docket No. 13-33), and the CFTC has at least two pending actions alleging similar violations. If *Butterfield* showed the CFTC's willingness to exercise its new false statements authority, this latest Order shows the CFTC's willingness to exercise such authority outside the context of formal testimony.

Whether the Order is a blip or a trend for holding an interviewee accountable for unsworn statements to CFTC staff remains to be seen. Regardless, the Order – particularly the magnitude of the penalty – sends a strong signal that the CFTC expects candor in *all* communications during investigations and breathes life into the adage, "There's no such thing as off the record."

FINRA Continues to Focus on Suitability of Complex, Non-Traditional ETFs

In mid-January, FINRA announced another settled disciplinary proceeding alleging unsuitable sales of levered and inverse exchange-traded funds (ETFs). This second such announcement in recent months involving non-traditional ETFs sends the clear message that FINRA continues to be intensely focused on the retail sale of complex structured products.

In the most recent consent order, FINRA alleged that between January 2009 and June 2013, certain registered representatives recommended levered and inverse ETFs to customers without fully understanding the unique features of the products. As a result, FINRA claimed that the representatives lacked "reasonable-basis" suitability for recommending the non-traditional ETFs to customers, some of whom had conservative investment objectives. Moreover, FINRA claimed that the firms lacked sufficient supervisory procedures over, and did not provide adequate training for, their representatives with respect to sales of the leveraged and inverse ETFs.

Due to the unique features of this type of product, FINRA advised its membership in a 2009 Regulatory Notice that non-traditional ETFs "typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets." FINRA's multiple actions in this area should alert its membership that recommendations of non-traditional ETFs, and firms' supervision and training thereof, will be closely scrutinized.

Adviser Violated Advisers Act by Charging Performance Fees to Non-Qualified Clients

A recent SEC enforcement action illustrates the kind of foot fault that can trip up a newly registered adviser not familiar with the requirements of the Advisers Act. In this case, the SEC found that the adviser violated the prohibition against charging performance fees to "non-qualified" clients.

Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers, and advisers required to register, from charging performance-based fees, that is, compensation based on a share of capital gains upon or capital appreciation of client assets. Rule 205-3 provides an exemption for charging performance-based fees to a "qualified client" as defined in Rule 205-3(d)(1). The adviser in this case offered interests in three private funds around the time that the Dodd-Frank Act amended the Advisers Act. Among other things, the amendments required the adviser to register with the SEC. Upon registration, the SEC said, the prohibitions on charging performance fees applied.

The SEC found that some investors in three private funds advised by the adviser were not qualified clients. Although the adviser asked potential investors to complete a questionnaire designed to determine if they were qualified clients, the SEC found that in most cases that questionnaire was not completed. As a result, all investors in the funds were charged a performance fee, in addition to a fixed asset-based fee, under the terms of the limited partnership agreements.

FINRA Continues Its Crackdown on Companies That Fail to Respond to Red Flags

FINRA continues to discipline broker-dealers that fail to detect and investigate so-called "red flags" of suspicious account activity. In a recent settlement order, FINRA fined a member firm $1 million for its failure to implement procedures designed to detect suspicious account activity and to report that activity once detected.

FINRA found a wide range of violations, but its emphasis was on anti-money laundering activity.

- FINRA found that while the firm identified those names of individuals and entities associated with high-risk accounts by using a "tagged identifier list," that list was only effective when cross-checked against a separate system which was not consistently populated by the firm's introducing brokers.
- FINRA also cited the firm for failing to ensure that its employees were aware of the criteria for identifying red flags that indicated suspicious activity.
- FINRA found that the firm's AML program relied on introducing firms for surveillance of suspicious activity, but the firm did not review those firms' AML programs.
- Finally, FINRA found the firm's use of manual reports for monitoring of suspicious activity to be inadequate because of the parameters set for those reports and the limited staff and resources devoted to the monitoring.

The settlement order follows several formal disciplinary proceedings brought by FINRA in 2013 addressing similar protocol failures at a number of other broker-dealers, discussed here. This recent case evidences FINRA's continued commitment to cracking down on firms whose procedures fail to sufficiently detect and report suspicious account transactions, as well as those who rely on others to do their monitoring without ensuring those firms have effective protocols in place.

SEC Sanctions Non-U.S. Firm for Failing to Register as Broker-Dealer/Adviser

The SEC charged a non-U.S. multi-national financial institution with a large U.S. presence with violating federal securities laws by providing brokerage and investment advisory services to U.S. clients without registering with the SEC.

The company agreed to pay $196 million to settle charges that it established as many as 8,500 accounts containing an average of $5.6 billion in assets since 2002 while failing to register as either a broker-dealer or investment adviser. The SEC said that the company's relationship managers used "jurisdictional means" to provide brokerage and advisory services to U.S. clients, including regular visits to the U.S. by its employees.

The SEC found that the company established compliance policies and procedures to prevent its employees from providing its services without proper registration. The company, however, failed to effectively implement or monitor those policies and procedures.

The SEC charged that the company violated Section 15(a) of the Securities Exchange Act of 1934 and Section 203(a) of the Investment Advisers Act of 1940 by failing to register as a broker-dealer or investment adviser. The Company agreed to pay $82 million in disgorgement, $64 million in prejudgment interest, and a $50 million penalty.

The high-profile settlement appears designed to send a message that non-U.S. companies with U.S clients must comply with U.S. federal securities laws.

DEPARTMENT OF CORRECTIONS

SEC Correction: Reinstating an Exception to an Exception to an Exception

No one could be blamed for having difficulty understanding the intricacies of the rules under Section 17(d) of the Investment Company Act, the statute that prohibits "joint transactions" without an SEC order. At the end of 2013, the SEC may have helped reduce some of the anxiety when it quietly reinstated a part of an obscure rule that was missing from the Federal Register since 2003.

Now follow closely: Rule 17d-1(d) under the 1940 Act provides a laundry list of exceptions to the requirement for obtaining an order. Researchers checking the official version of the law would find that the exception contained in Rule 17d-1(d)(6) included an exception to the exception that is difficult, if not impossible, to understand, with a reference to another section that didn't exist. It turns out that when the SEC amended the rule in 2003, the adopting release incorrectly included a cross-reference to a section that was renumbered, and inadvertently omitted three paragraphs (i.e., (d)(6)(i)-(iii)) that should have followed immediately after the exception to the exception. The missing paragraphs provided an exception to the exception to the exception. In December, the SEC corrected this decade-old omission from the Federal Register.

Now everything is crystal clear.

TIDBITS

- On February 20, 2014, the SEC announced that Sharon Binger was appointed as director of the agency's Philadelphia Regional Office. Ms. Binger joined the SEC's enforcement division in 2008 and, since 2011, has served as assistant regional director of the SEC's New York office.

- On February 14, 2014, the SEC announced its intention to host a roundtable to discuss cybersecurity and related issues and challenges for market participants. The roundtable is scheduled to be held at the SEC's Washington, D.C. headquarters on March 26, 2014.

- On February 12, 2014, the SEC announced that Paul Leder was named director of the agency's Office of International Affairs, which advises the SEC on cross-border enforcement and regulatory matters. Mr. Leder joined the staff from a Washington, D.C. law firm, but he was a member of the SEC staff from 1987 to 1999, including several years in the Office of International Affairs when it was first formed.

- Rick Fleming was named as the SEC's Investor Advocate. In this role, he will lead an office charged with assisting retail investors in interactions with the SEC and with self-regulatory organizations (SROs) such as FINRA. Mr. Fleming previously served as the deputy general counsel of the North American Securities Administrators Association (NASAA) from October 2011.
- On January 28, 2014, the SEC announced that Barbara Lorenzen was named the national associate director for OCIE's Clearance and Settlement Program which, among other things, examines clearing agencies and oversees approximately 450 U.S. transfer agents. Ms. Lorenzen was previously with the SEC's Chicago regional office.
- At the beginning of the year, the SEC announced that Enforcement Co-Director George Canellos would leave the agency's staff. Mr. Canellos joined the staff in July 2009 as the director of the SEC's New York regional office and has served on the Enforcement staff since 2012.
- In January, the SEC's Office of Municipal Securities issued a series of frequently asked questions related to the implementation of its final rules for the registration of municipal advisors. Like any of the staff's FAQs, the questions and answers are subject to periodic updating.

CONTACTS

Jay G. Baris
(212) 468-8053
jbaris@mofo.com

Kelley A. Howes
(303) 592-2237
khowes@mofo.com

Isabelle Sajous
(212) 336-4478
isajous@mofo.com