Institutional Investor

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Implementing Today's Regulations for Asset Managers and Brokers

# Compliance Reporter

The bi-weekly issue from Compliance Intelligence www.complianceintel.com

## In This Issue



***Where's The Recruitment Boom?***

## Private Advisers Slow To Hire CCOs

The influx of hundreds of hedge fund and private equity fund firms to **Securities and Exchange Commission** registration has not created the expected flood of compliance hires, surprising industry professionals. Some firms are in the market for new bodies, but others have turned to third-party providers.


*Steven Felsenthal*

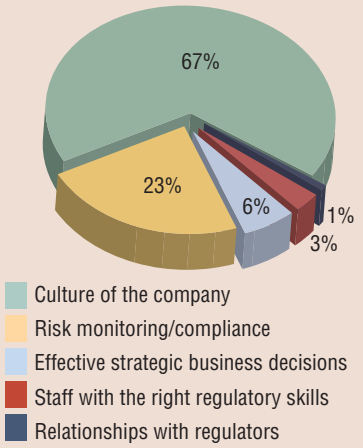
"I don't see a ton of hiring going on and I haven't seen that many new positions, which surprises me," **Steven Felsenthal**, chief compliance officer and general counsel at Greenwich, Connecticut-based **Millburn Ridgefield Corp.**, told *CI*.

The Dodd-Frank Act forced private fund advisers with more than $150 million in assets under management to register with the SEC by the end of March 2012. According to a recent study by the **Investment Adviser Association** and **National Regulatory Services**, roughly 1,500 did so (CI, 11/12). That population now has to have SEC-specific compliance programs, deal with new exams and cope with tricky requirements such as filing Form PF. But many of these firms are trying to adapt to the regulatory regime incrementally and delaying the recruitment of new

*(continued on page 15)*

**READY FOR THE NEW YEAR?**

***In a firm's government function, what is the most important factor to get right in order to avoid major regulatory problems?***




*For more details, see page 2.*

**Source: Kinetic Partners**

## IM CCOs: What's In Store For 2013

Chief compliance officers in the investment management world in 2013 will face a range of issues almost as varied as the industry itself. Newly enrolled private advisers have a whole new regulatory landscape to contend with, while those that have traditionally operated under **Securities and Exchange Commission** oversight will have to contend with new wrinkles in existing regulations, as well as potentially having to balance multiple regulators.

In this second part of our look at the year ahead for advisory CCOs, *CI* examines some of these key challenges through the eyes of industry professionals.

*(continued on page 14)*

## IAs Face Decision Over FINRA Arbitration

The **Financial Industry Regulatory Authority** has decided to open the doors of its arbitration and mediation forums to investment advisers, which traditionally have thrashed out disputes with their clients in court or other arbitration venues. Arbitration holds many appeals, such as offering a speedier, cheaper alternative to litigation. But there are also possible drawbacks, particularly for IAs operating in a system designed for broker/dealers. This week's *Compliance Clinic* takes a look at the potential pros and cons, including keys issues such as discovery and dispositive motions.

*(See Compliance Clinic, page 12)*

## Around The Industry

# Damned If You Do…

Regulators often seem to be between a public opinion rock and a political hard place. If they get too tough on the industry (or perhaps just implement a congressionally-mandated rule) they're accused of cramping the economy. If they miss a major fraud or fail to have Wall Street bosses locked up they're "asleep at the wheel."

Of course, government authorities—as with any group involved in the regulatory world—are by no means without fault. But they also get little credit when doing what has been asked of them. For example, agencies on both sides of the Atlantic have been criticized for not being tough enough cops. And yet recent figures suggest these are record-breaking times for enforcement teams. The **Financial Industry Regulatory Authority** last week said it ordered a record $34 million in restitution to harmed customers in 2012. For its part, the **Securities and Exchange Commission** brought 734 actions in fiscal year 2012, just one less than the record—which it set in 2011.

Meanwhile, the U.K. **Financial Services Authority** is scheduled for dismemberment later this year, at least partially because of its much-touted and later much-derided "light touch" approach. Ironically (or perhaps because of changes in leadership and the kick of criticism), the *Financial Times* reported recently that the FSA handed down a record £312 million ($500 million) in fines last year, more than triple its previous top haul of £89 million in 2010.

Whatever regulators do, they're unlikely to find themselves in the good books of many business leaders. A recent global survey by consulting firm **Kinetic Partners** found that just 36% of CEOs and directors at financial services firms believed current regulatory plans will make the financial world more stable. There was also a split between business and compliance teams: Just 16% of CEOs polled thought new regulation would make the industry more stable, while 47% of chief compliance officers were optimistic. That's hardly a ringing endorsement from CCOs, though.

If reforms are going to work, they need buy-in from the industry as much as from those that oversee it—and that still seems to be a long way off. CCOs and their colleagues are working flat out to implement new rules. But the business side will have to accept the changes if they're going to be effective. Whether they like them or not, that may just be the way of the world right now. And it may be better to be working with the tide—hoping the reforms bring the promised reductions in fraud and crises—than battling against it.

This issue of *Compliance Reporter* (the biweekly publication from *Compliance Intelligence*) takes its latest look at some of those efforts to protect investors, and how regulators and the industry are coping. These range from guidance on FINRA's new suitability rule (see story, page 3) and **Commodity Futures Trading Commission** proposals to safeguard client funds (see story, page 4) to the continuing regulatory and trading fallout from Hurricane Sandy (see story, page 5) and debt research reforms (see story, page 6).

Among other highlights, we look at recruitment among hedge and private equity fund firms (see story, page 1), plus new law firm hires from **Goldman Sachs** (see story, page 7) and the **U.S. Attorney's Office for the Southern District of New York** (see story, page 11).

Please let me know if you have any questions or comments.

Best regards,
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Institutional Investor Intelligence

## Broker/Dealer

***Potential Clients***

# CCOs Get Relief On Suitability Rule

Chief compliance officers at broker/dealers were handed some welcome relief last month on one of the major challenges of 2012—the **Financial Industry Regulatory Authority**'s new suitability rule.

Rule 2111, which came into effect on July 9, expanded the factors relevant to a suitability determination to include an investor's age, investment experience, time horizon, liquidity needs and risk tolerance. Among other things, it governs investment strategies, including recommendations to hold securities.

A key concern for CCOs in recent months has been the definition of a customer. FINRA guidance released in May stated that, "A broker-customer relationship would arise and the suitability rule would apply, for example, when a broker recommends a security to a *potential* investor, even if that potential investor does not have an account at the firm."

Professionals called this an expansion of FINRA's traditional definition, and said it raised the specter of being deemed to have entered into a suitability scenario and the resulting potential liability while, for example, chatting at a cocktail party (CI, 6/28).

The new guidance, however, states that the suitability rule would apply when a B/D or rep makes a recommendation to a potential investor who then becomes a customer. The rule "would not apply to the recommendation…if the potential investor does not act on the recommendation or executes the recommended transaction away from the [B/D] with which the [rep] is associated without the [B/D] receiving compensation for the transaction," officials wrote.

The new guidance largely resolves professionals' concerns and follows pressure from the industry, **Sutherland Asbill & Brennan** Partner **Clifford Kirsch** told *CI*, adding that it makes clear firms are able to make suitability determinations at the time an account is opened, rather than at the time of an initial informal conversation. Firms' concerns had been mitigated in recent months by FINRA's suggestion that they take a risk-based approach to compliance, suggesting that it didn't expect B/Ds to have robust policies and procedures regarding potential customers if they were not deemed to constitute a major risk, Kirsch said.

*Clifford Kirsch*

The December guidance also revisits the treatment of suitability obligations attached to a recommendation to buy or sell a non-security product, making clear that they only apply if there is a security and non-security component to the transaction. For example, if a rep recommends that a client get a mortgage there is no suitability concern. But if the rep recommends that the client sell stocks in order to buy a house the suitability analysis applies to both parts of the transaction.

**Susan Axelrod**, head of FINRA's Member Regulation Sales Practice area, told *CI* recently that the industry as a whole has responded well to Rule 2111's compliance requirements (CI, 12/21). But the self-regulatory organization will be keeping a close eye on the area in 2013. "A very small number of firms have not effectively worked to comply and obviously we will work with those firms on a different track," she added.

**THE BOTTOM LINE:**

*The new guidance states that the suitability rule would apply when a B/D or rep makes a recommendation to a potential investor who then becomes a customer.*

# Citi Unit Fined $575K In CDO Case

**Citigroup Global Markets** (CGMI) has agreed to pay a $575,000 fine and be censured to resolve allegations concerning its supervision of efforts to reduce **Citigroup**'s exposure to subprime assets.

Citigroup liquidated certain collateralized debt obligations by selling the assets held within them at auction, the **Financial Industry Regulatory Authority** said. The task of reducing this exposure while maximizing value fell to a trading desk known as the Long Term Asset Group, or LTAG, the self-regulatory organization said. Citigroup's Capital Markets Approval Committee, or CMAC—which was composed of representatives from control functions such as compliance, accounting and market risk—evaluated and approved the liquidation of each CDO, FINRA said.

According to FINRA, between April 1, 2009, and March 30, 2010, CGMI incurred trading losses of $464 million when it bought distressed assets during blind auctions held in connection with the liquidation of CDOs. The purchases benefited CGMI's banking affiliate, **Citibank**, which was the holder of the super senior notes of the CDOs, FINRA said. The losses occurred mainly because, under a strategy to minimize losses to parent entity Citigroup, the trading desk placed par bids on behalf of CGMI on assets where the fair market value could not be estimated, the SRO alleged.

Some of the bids were later determined to be above fair market value, against company policy governing intercompany transactions and also contrary to specific conditions placed on the trading desk, FINRA said. CGMI lacked an adequate system to monitor, review and follow up on the auctions—preventing it from discovering and addressing the par bids or the associated losses for nine months, FINRA added.

In addition, the SRO alleged, CGMI incorrectly recorded $464 million in trading losses from bidding on the underlying assets of CDOs in which Citibank held the super senior notes; inaccurately recorded a tax write-off of $184 million; and filed inaccurate Financial

and Operational Combined Uniform Single, or FOCUS, reports.

CMAC based its approval of each liquidation on the understanding that all bids be placed at fair market value, FINRA said. The fair market value requirement was codified in the written supervisory procedures of Citigroup, the SRO added, noting that exemption from the market terms requirement required written approval from the legal department. Despite Citigroup's written policies and procedures, CGMI did not adequately supervise LTAG to ensure it bid fair market value on all assets, FINRA said.

FINRA alleged CGMI's supervision of LTAG was inadequate for three reasons:

- CGMI did not have an adequate system to address the potential conflict between the competing economic interests that arose when LTAG bid for CGMI on assets in which Citibank had a beneficial interest
- There was no system, procedure, person or entity assigned the responsibility of reviewing whether CGMI's bids were submitted at fair market value
- CGMI failed to respond adequately to red flags suggesting that LTAG was not bidding fair market value on certain assets in the auction, such as the large immediate losses at certain auctions

CGMI submitted a letter of acceptance, waiver and consent to resolve the matter without admitting or denying FINRA's findings. FINRA has accepted the AWC, and the SRO stated that the sanctions took into account CGMI having self-reported the issues described in the proceeding and having taken corrective action. **Linda Chatman Thomsen** of **Davis Polk & Wardwell**, CGMI's counsel on the proceeding, had no comment.

# FIA Frets Client Fund Plans

The **Futures Industry Association** is gearing up to undertake a wide-ranging analysis of plans to boost customer fund protections in the futures industry, and has already raised concerns about the proposal.

The **Commodity Futures Trading Commission** has proposed reforms designed to enhance customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosures and auditing and exam programs for futures commission merchants, or FCMs.

The CFTC hopes the plans will give greater confidence to market participants that, among other things, customer segregated funds and secured amounts are protected; customers are notified of the risks of futures trading and of FCMs; and that FCMs are monitoring and managing risks properly (see box). The agency developed the proposal following the collapses of **MF Global** and **Peregrine Financial Group**.

In a recent comment letter, FIA President **Walt Lukken** asked the CFTC to extend the deadline for feedback on the rule by a month to Feb. 13, 2013. "This is a complex rulemaking, which affects not only [FCMs], both clearing and non-clearing, but also their affiliates, their depositories and, most important, their customers," he wrote. "Proper analysis of the proposed rules requires input from these entities in addition to virtually every segment of an FCM's business, including financial reporting, operations, compliance and legal."


To respond to the CFTC's plan, FIA has set up four subcommittees comprising roughly 100 representatives from member and associate member firms. The industry group is also planning to hire a consultant to collect and analyze select FCM financial data.

FIA is concerned about the potential impact of the planned financial rules. "We note, in particular, that the Commission's analysis of the potential costs of the proposed requirement that an FCM's residual amount must exceed its customers' aggregate margin deficits appears to focus solely on: (i) the potential limitation on investment options that would be available to FCMs; and (ii) the potential desire of some FCMs to increase their capital to meet operational needs," Lukken said. However, the industry group's analysis suggests these costs will be so "benign," he added.

"We believe that the proposed rules are likely to require customers to prefund potential margin obligations and, as a consequence, will have a substantial financial impact on customers, especially those that use the futures markets to hedge their commercial and financial

**CLIENT $$$**

*Among other things, the CFTC's proposal would:*

- Require each FCM that carries customer funds to determine a necessary level of excess segregated and secured funds that the firm should hold in segregated or secured accounts to ensure against becoming under-segregated or under-secured as a result of the withdrawal of proprietary funds from segregated or secured accounts
- Require each FCM that carries customer accounts to establish a risk management program designed to monitor and manage the risks associated with the firm's activities as an FCM. It would also require that: the risk management program consist of written policies and procedures; such policies and procedures be approved by FCM's governing body; and a risk management unit, independent from the business unit, is established to administer the program
- Restrict an FCM's use of customer funds. For example, it would bar an FCM from using one futures customer's funds to margin or secure another futures customer's positions

risks," Lukken said. "Further, the increased costs imposed on FCMs will adversely affect the ability of many FCMs to compete effectively."

***Owner Or Client?***

## SEC Clarifies B/D Capital Situation

The **Securities and Exchange Commission** has offered clarification about drawing the line between owners and clients of broker/dealers, potentially avoiding confusion over capital contributions.

The **Financial Industry Regulatory Authority** wrote to staffers at the SEC's Division of Trading and Markets last month seeking no-action relief on the topic. **Krisoula Dailey**, v.p. for member regulation, risk oversight and operational regulation at FINRA, wrote that in the course of surveillance and exam activities, FINRA officials have observed situations in which a B/D establishes one or more classes of ownership under which the relationship between the firm and the individuals that fall within those ownership classes resembles the relationship between a B/D and a customer.

"FINRA staff is concerned that, absent the existence of specific written agreements between the [B/D] and such persons, outlining the nature of the relationship and other applicable conditions of the arrangement, the treatment of such persons' contributions in the [B/D] as equity capital of the [B/D] may be incorrect," Dailey wrote. She added that FINRA had identified certain facts and conditions that its staff believes must be present in such arrangements in order for the firm to be able to classify such individuals as owners—and not customers—for the purposes of Rule 15c3-3, and their contributions in the firm as equity capital for purposes of Rule 15c3-1 (see box).

**COMPLIANCE PRIMER:**
**Broker Capital, Margin**

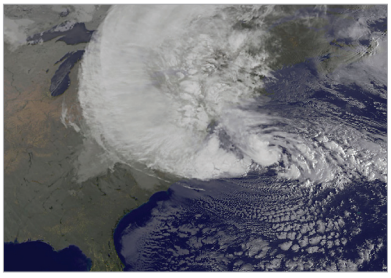
- Securities Exchange Act Rule 15c3-3 governs reserve requirements for margin related to security futures products
- Exchange Act Rule 15c3-1 governs net capital requirements for brokers or dealers

The FINRA letter outlined these facts and conditions. The SEC stated it would not recommend enforcement action if a B/D were to classify a person in one or more classes of ownership as an owner of the firm (and not a customer) and such person's contributions as equity capital for purposes based on those conditions, which included:

- The B/D obtains an opinion from independent legal counsel that: it is duly formed, validly existing and in good standing; and its governing documents are enforceable in accordance with their terms
- Upon request by the SEC or FINRA, the B/D must be able to establish that the person is an equity participant in the firm under applicable law in the jurisdiction in which the B/D was formed, organized or incorporated
- The relationship between the person and the B/D, and all applicable conditions of the arrangement, must be documented in an executed writing wherein the parties agree and acknowledge that:
  - i) the person is not a customer of the B/D with respect to any such contributions, any subsequent contributions, as well as any related profits
  - ii) the person's contributions in the B/D, any subsequent contributions, as well as any related profits are subject to all risks of the B/D's business.

## Sandy Relief: SEC Tackles Trapped Certificates

The **Securities and Exchange Commission** has offered more regulatory relief for firms affected by Hurricane Sandy—this time over physical securities certificates trapped by flooding in downtown New York.


*Hurricane Sandy*

Regulators offered various short-term relief to firms in the wake of the storm in late October. They are also keen to learn how the storm impacted the industry. For example, the **Financial Industry Regulatory Authority** has sent letters to members requesting information about firms' operations and their ability to keep going while business continuity plans were in force (CI, 12/21).

In late December, the **Securities Industry and Financial Markets Association** asked the SEC for aid on what it said was the inability of clients and broker/dealers to access to securities held in physical form in the name of the owner within the **Depository Trust & Clearing Corp.**'s (referred to in the correspondence as DTC's) vault at 55 Water Street. The vault had become inaccessible due to flooding of the building, SIFMA said, adding that DTC had announced it keeps backup electronic records of the physical certificates and had said it would issue replacement certificates.

SIFMA General Counsel **Ira Hammerman** wrote that the inaccessibility of the physical certificates means B/Ds face the following regulatory issues:

- Delivery time frames under the customer protection rule
- Capital charges for aged fails under the net capital rule
- Automated Customer Account Transfers (ACATS) of accounts that have "safekeeping positions"
- Buy-ins under the Uniform Practice Code when there is a fail because of lack of access to physical certificates

SIFMA asked the SEC that—for the purposes of Rule 15c3-3—in the event of a fail to receive, a buying broker would be allowed to rely on a selling broker's written representation that the fail allocates to securities acknowledged as having been received by DTC.

Among other things, the industry group requested that a buying B/D be allowed to treat the time periods for requiring buy-ins under Rule 15c3-3 as tolled until DTC's vault and processing operations are back on line.

The staff of the SEC's Division of Trading and Markets replied that it would not seek enforcement action with regards to physical certificates trapped in the vault, subject to conditions including that:

- A B/D continues to treat the vault as a so-called "good control location" under Rule 15c3-3(c)(1) for the customer securities held there that DTC has acknowledged receiving. All unsold customer securities DTC does not acknowledge having received must be included as a credit item in the reserve formula. To the extent there is a debit based on securities DTC does not acknowledge having received, a B/D must take a capital charge and exclude the debit from the reserve formula
- A buying B/D treats the time periods for requiring buy-ins under Rule 15c3-3 as tolled. If there is a fail to receive, a buying B/D can rely on a selling B/D's written representation that the fail applies to customer securities DTC acknowledges receiving
- A B/D may disregard the three business day aging requirement for fails to deliver, but must reduce such debits by: (i) the excess of the contract price of the fail to deliver contract over the market value of the underlying security; and (ii) the applicable haircut on the security under Rule 15c3-1(c)(2)(vi)

In addition, SIFMA asked FINRA give interpretive guidance and relief regarding ACATS of customer accounts and buy-ins under the FINRA Uniform Practice Code when there is a fail due to a lack of access to physical certificates. At the time of writing, the self-regulatory organization did not appear to have responded formally.

Officials from DTC and FINRA had no comment.

# Concerns Remain On Debt Research Plan

The **Bond Dealers of America** has expressed concern about revised plans to introduce debt research rules for broker/dealers, questioning aspects such as the institutional investor exemption.

The **Financial Industry Regulatory Authority** in February 2012 issued a proposal designed to address debt research conflicts of interest. In general, the proposal would give retail customers the same protections provided to recipients of equity research, while exempting debt research distributed solely to eligible institutional investors.

The self-regulatory organization issued a revamped proposal late last year based on industry feedback. Among other things, several commenters were worried about the original provision requiring otherwise eligible institutional investors to affirmatively elect to receive institutional debt research.

FINRA's response was to propose creating a higher tier of institutional investors that could receive institutional debt research without giving written agreement. Rather, B/Ds would be able to obtain agreement by way of negative consent, if institutional investors opt not to notify the firm they wish to be treated as retail investors. To qualify for this exemption, an institutional investor would have to:

- Meet the definition of qualified institutional buyer, or QIB
- Satisfy FINRA Rule 2111's institutional suitability standards, which require that: (i) the member has a reasonable basis to believe the institutional investor is capable of evaluating investment risks independently; and (ii) the QIB has indicated affirmatively that it is exercising independent judgment in evaluating the firm's recommendations

In a recent comment letter, BDA CEO **Michael Nicholas** said the revised approach to excluding institutional investors "does not address our underlying concern. We believe that the debt research report rules should categorically exclude [QIBs] from their scope." The only obligation for a firm should be to ensure that the institutional investor is a qualified QIB, he added. As such, Nicholas wrote, FINRA should drop the requirement that, to be excluded, QIBs must affirmatively indicate that they are exercising independent judgment in evaluating the dealer's recommendations. The rule should categorically exclude QIBs and then impose requirements for other "institutional accounts" similar to the suitability standards for such accounts under Rule 2111, he added.

BDA argued that, among other things:

**PROPOSAL REVAMP**

*Other changes to FINRA's proposal include:*

- Conforming the definition of "debt research report" to the **Securities and Exchange Commission**'s Regulation Analyst Certification definition and clarifying that it covers an analysis of either a debt security or an issuer and excludes reports on types or characteristics of debt securities
- Requiring disclosure of material conflicts that are known or should have been known by the member firm or debt analyst at the time of publication or distribution of the report. This standard replaces the originally proposed requirement to disclose "all conflicts that reasonably could be expected to influence the objectivity of the debt research report"
- Deleting the provision that prohibited joint due diligence by debt research analysts and investment banking personnel, conforming to the equity research rules and a change to the 2003 Global Settlement

- The proposal should exclude trading and sales reports in regards to institutional investors
- The proposal should exclude agency obligations, just as U.S. Treasuries are excluded
- Although the revised proposal states that the debt research department's budget may take into consideration the revenues and results of the firm as a whole, a similar clarification should be added with respect to the compensation of debt research analysts.

# ITG Settles Short Sale Allegations

New York-based ITG has agreed to pay a $300,000 fine to resolve allegations concerning its compliance with and supervision regarding short sale requirements.

The firm submitted a letter of acceptance, waiver and consent to settle the **Financial Industry Regulatory Authority** proceeding without admitting or denying wrongdoing. The self-regulatory organization has accepted the AWC. **P. Mats Goebels**, ITG's general counsel did not return a call.

For the period between Jan. 1, 2007, through Dec. 31, 2011, FINRA enforcement officials reviewed ITG's compliance with the **Securities and Exchange Commission**'s July 15, 2008, Emergency Short Sale Order and the use of certain exemptions to the locate requirement of Rule 203(b)(1) of Regulation SHO (see box).

According to the SRO, between July 22, 2008, and Aug. 12, 2008, ITG executed 1,562 customer short sale orders in the securities of 16 financial services companies identified in the SEC's emergency order without having borrowed or arranged to borrow the security.

The firm also failed to implement a supervisory system reasonably designed to achieve compliance with the emergency order, FINRA said. Four customer accounts that ITG had improperly exempted from Reg. SHO's locate requirement maintained that status while the July emergency order was in effect, the SRO said. By maintaining this exempt status, these customer accounts were capable of effecting short sales without having to establish that the shares in question had been borrowed or pre-borrowed prior to execution, according to FINRA.

By miscoding customer accounts in this fashion, ITG failed to adequately implement system changes that resulted in 1,562 short sale orders being executed during the emergency order period and the firm's supervisory system failed to include adequate supervisory steps and procedures reasonably designed to detect and prevent violations of the order, FINRA said.

In addition, the SRO alleged that between Jan. 1, 2007, and Aug. 24, 2010, ITG misapplied exceptions to Reg. SHO's locate requirement by improperly designating 11 customer accounts as exempt. As a result, from Jan. 1, 2007, through May 24, 2010, five of these accounts effected 25,362 short sale orders without valid locates, FINRA said.

The firm's supervisory system failed to include adequate supervisory steps and procedures reasonably designed to detect and prevent violations of Reg. SHO's locate requirements, FINRA added. By miscoding customer accounts as exempt from the locate requirement, the SRO said, ITG failed to implement an adequate supervisory system to achieve compliance with Rule 203(b)(1) between Jan. 1, 2007, and Aug. 24, 2010.

### COMPLIANCE PRIMER: SELLING SHORT

*Emergency order.* The SEC on July 15, 2008, issued an emergency order adopting a temporary rule to Reg. SHO that imposed enhanced borrowing and delivery requirements on short sales of the equity securities of certain major financial institutions. It stated that no person could effect a short sale in the publicly traded securities of these firms unless the person or their agent borrowed or arranged to borrow the security, or otherwise had the security available to borrow in its inventory, before effecting such short sale.

*Rule 203(b)(1).* Rule 203(b)(1) of Reg. SHO states that, subject to certain exceptions, a "broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) documented compliance with this paragraph (b)(1)."

## Investment Management

# Senior Goldman Attorney Joins Morgan Lewis


*Will Iwaschuk*

**Will Iwaschuk**, an equity derivatives and equity sales and trading attorney at **Goldman Sachs**, has joined **Morgan, Lewis & Bockius** as a partner in the firm's investment management and securities industry practice, based in New York.

Iwaschuk, who began work at the law firm Jan. 2, most recently served as associate general counsel at Goldman, where he helped the firm implement changes brought about by Title VII of the Dodd-Frank Act and the Volcker rule. He had been at Goldman since 2005. At Morgan Lewis he will assist clients in navigating Dodd-Frank protocols and other requirements, and in creating compliance policies, he told *CI*.

"Not surprisingly, we think Dodd-Frank is going to continue to be a big focus for our clients in 2013," Iwaschuk said. "The rules are extremely complex and many are interconnected." Even something

as simple as dealing with the timing of when the different rules go into effect can be a complicated reckoning, he said.

Iwaschuk has worked with industry groups such as the **International Swaps and Derivatives Association**, where he worked with committees that drafted standardized equity derivatives confirmations, and the **Securities Industry and Financial Markets Association**, where he assisted on derivatives products committees.

A spokesman for Goldman Sachs declined to comment.

## SEC's Karpati Eyes Solicitation, Incentives Risks

A senior **Securities and Exchange Commission** enforcement official has flagged plans to drop a ban on general solicitation and misalignments of incentives as potential causes for concern in the hedge fund industry.

As mandated by the Jumpstart Our Business Startups, or JOBS, Act, the SEC has proposed amending Rule 506 of Regulation D to nix the bar on general solicitation and general advertising for certain private offerings. Most private investment funds use Rule 506 of Reg. D to ensure offerings of their securities are not subject to registration.

Although the JOBS Act is intended to promote capital formation, many observers are worried the general solicitation reform will leave investors exposed to potential fraud by reducing transparency and nixing conflicts of interest protections.


*Bruce Karpati*

**Bruce Karpati**, head of the SEC Enforcement Division's asset management unit, echoed these concerns at a recent conference, noting that in general the so-called retailization of hedge funds has made it easier for unsophisticated investors to invest directly in such instruments. Talking about the JOBS Act proposal, he said, "We understand that this may facilitate capital formation, but one of our concerns is that these retail-oriented hedge funds may be offered to investors that may have the financial wherewithal to meet accredited investor standards but are otherwise financially unsophisticated."

Karpati is not the only SEC official with concerns. New Chairman **Elisse Walter** has said a framework of investor protections needs to be in place before the Commission allows private companies to solicit investors (CI, 11/28).

The agency last year saw an influx of roughly 1,500 private fund advisers as those with more than $150 million in assets under management were required by the Dodd-Frank Act to register for the first time (CI, 11/12). But Karpati remains concerned about those smaller firms that fall under the threshold and are not forced to enroll.

"Unregistered advisers may not have effective compliance policies and procedures to prevent fraud and other violations, are not subject to inspection by exam staff and need not comply with the Commission's advertising rules applicable to registered advisers," he told delegates. "Knowing that a disproportionate amount of fraud occurs at smaller hedge fund advisers, the [asset management unit] is concerned that unregistered advisers may engage in general solicitation without the proper policies in place to ensure that only accredited investors invest."

Karpati also raised concerns that the rapid growth of the industry and often opaque business models mean that there can be misalignments of incentives between investors and advisers. For example, he said:

- Since hedge fund managers are compensated by both management fees and performance fees, the manager has incentives to over-prioritize compensation
- The hedge fund business model and industry growth put pressure on managers to demonstrate and market consistently positive performance, even while it has become harder for individual funds to yield the high returns that hedge fund investors have come to expect
- Severe conflicts of interest can arise because some hedge fund managers may control every aspect of their business
- Advisers may have the opportunity and incentive to give favored treatment to certain investors through preferential redemptions or side letters
- The lack of independent governance for many hedge funds makes them more susceptible to conflicts of interest, insider trading and other fraudulent practices. The asset management unit has been focusing on making sure registered advisers have proper compliance procedures and controls in place.

***Groups To Appeal***

## Funds Press On With CPO Prep

Mutual fund firms are moving ahead with their compliance efforts after a court upheld the **Commodity Futures Trading Commission**'s commodity pool operator registration and reporting rule, according to **Bingham McCutchen** Partner **Joshua Sterling**.

The **Investment Company Institute** and the **U.S. Chamber of Commerce** have been trying to get the rule overturned, arguing that its costs outweigh the potential benefits (CI, 4/18). The **U.S. District Court for the District of Columbia** last month rejected their efforts, upholding Rule 4.5, though the industry groups have filed a notice of appeal.

The industry is still awaiting the final form of a CFTC plan intended to harmonize disclosures required by the **Securities and Exchange Commission** for firms that are already registered with that agency. But firms had a Dec. 31, 2012, deadline to enroll with the CFTC.

"What we saw in the market was that firms that needed to register weren't waiting for the outcome of the case," Sterling said. Firms are planning ahead and beginning to think about the timing, technology and personnel that will be needed under the harmonization rules the CFTC has proposed, he said. "It's going to continue to be a bit of a juggling act for firms."

For example, Sterling said, registered mutual fund firms are examining how they will undertake major reporting initiatives such as completing Form CPO-PQR, even though they won't be required to file it until the harmonization release comes out—meaning that the filing is unlikely to be an issue in the first quarter. The form is similar to the SEC's Form PF, which was considered one of the most difficult compliance assignments of the past year.

In the meantime, ICI and the Chamber of Commerce intend to argue that the cost of overlapping regulation by the CFTC and SEC will harm shareholders of registered funds in its appeal of the district court's ruling, the Chamber's **David Hirschmann** said in a recent statement. The **U.S. Court of Appeals for the District of Columbia Circuit** has a history of being tough on regulators, particularly in regards to cost-benefit analysis, Sterling said, adding that the lower court's decision was nonetheless "fairly powerful" and may be difficult to overturn.

Officials at the CFTC, ICI and Chamber of Commerce did not respond to requests for comment.

## Canadian Regs Weigh Fund Fee Revamp

Canadian regulators are considering whether to adopt regulatory reforms that would alter the manner in which mutual fund investors incur fees to pay for the continuing expenses and management of the funds.

The **Canadian Security Administrators** published a paper last month outlining several possible changes to the current fee structure (see box), as the regulators under the CSA's umbrella try to determine whether alternative methods of assessing charges would better inform clients of mutual fund costs. The deadline to submit feedback on the various concepts is April 12.

Until now, the CSA has focused its efforts on enhancing the transparency of mutual fund fees and commissions through initiatives such as the point of sale and cost disclosure and performance reporting projects, but has decided to expand its look at the issue.

The consultation and possible reform options are focused on trailing commissions paid to advisers, which are embedded within the management fees of most Canadian mutual funds. These are fees advisers receive each year that a client owns an investment or keeps money in an account. Among the options the CSA has put on the table are: explaining the purpose of trailing commissions; unbundling trailing commissions from other management fees; or prohibiting fund manufacturers from setting the level of adviser compensation.


*Simon Romano*

"These would be big changes in the Canadian mutual fund field and would need to be carefully thought out," **Stikeman Elliott** Partner **Simon Romano** told *CI*. "Several of the Administrators' ideas, such as prescribing fiduciary duties for sales representatives—which could have a significant impact on industry structures depending on how they were implemented—are already being considered in other forms in existing regulatory proposals," he said. "Other ideas, such as banning fund manufacturers from paying embedded compensation to advisers, would represent a larger change."

Regulators in the U.K. and Australia have banned financial product providers from setting commissions or embedding such fees, and the CSA plan to monitor the consequences of those decisions, officials wrote in a related filing, adding that the effects of the new rules may not be fully evident for several years.

The new concept proposals come after the CSA last summer rejected industry calls to drop a planned requirement for firms to disclose the dollar amount of trailing commissions (CI, 6/25).

**ON THE AGENDA:**

**Mutual Fund Fees**

*The CSA has invited comment on seven possible changes to regulation of mutual fund fees:*

- The purpose of trailing commissions could be made explicit in disclosures to investors, and a minimum level of service required of advisers if they are to receive the fee
- Every mutual fund could have a cheaper class of securities for investors who don't desire an adviser's guidance
- Trailing commissions could be broken out and instead charged and disclosed as a separate asset-based fee to the fund
- Mutual funds could offer separate classes or series of securities for each purchase option, such as front-end sales charge, low load and no load
- A limit could be placed on the percentage of fund assets that could be used to pay trailing commissions
- A standard of conduct could be imposed on advisers requiring them to put clients' best interests first
- Fund manufacturers could be stopped from determining the level of payments to advisers

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Feel free to contact **Ben Maiden**, managing editor, at (212) 224-3281 or bmaiden@iiintelligence.com.

## Policy & Oversight

# NY Prosecutor Joins Crowell & Moring


*Glen McGorty*

**Glen McGorty**, a federal prosecutor with the **U.S. Attorney's Office for the Southern District of New York**, has joined the white collar and regulatory enforcement group at Crowell & Moring.

McGorty, who began work as a partner in the law firm's New York office last month, previously served as senior assistant U.S. attorney. He led criminal investigations for the SDNY's Securities and Commodities Task Force and assisted in the prosecution of securities fraud, insider trading and public corruption cases, among other matters.

"I was on the other side of large internal investigations as a prosecutor and now I hope to be able to run them from the defense side," McGorty told *CI*. "The use of electronic surveillance and traditionally non-white collar tools such as wiretaps has been pushed hard by [U.S. Attorney for the SDNY **Preet Bharara**] in the insider trading context, so I would expect see more insider trading cases."

McGorty has also led investigations for the SDNY's International Narcotics Trafficking Unit and handled cases involving drug trafficking, racketeering, violent crimes and wire and mail fraud. At Crowell & Moring he will focus his practice on white collar crime and enforcement actions.

The U.S. Attorney's Office did not respond to a request for comment.

***Synthetic Deals***

# Industry Expects More CFTC Securitization Relief

The **Commodity Futures Trading Commission** is likely to issue by March 31 a third no-action letter regarding the use of derivatives in securitizations, according to industry players.

This time, the letter would address certain kinds of synthetic securitizations, including the stalled risk-sharing deals planned by **Freddie Mac** and **Fannie Mae**, which would use credit default swaps to transfer the credit risk of securitized loans to private investors. Until now, bonds issued by the government-sponsored enterprises were backed by the government's implied guarantee, as well as insurance wraps.

Industry officials expect the CFTC to issue another no-action letter by March 31; the extended deadline for compliance with its guidelines. The CFTC's last no action letter, issued Dec. 7, provided exemption to cash-flow collateralized loan obligations from the definition of commodity pool, and was considered a major victory for the industry over new regulations that could unintentionally hinder the securitization market.

Originally, the agency had defined any investment that included swaps as a commodity pool. That would have meant that securitizations, which use swaps to hedge currency and interest rate risk and provide credit enhancement to investors, among other things, would have been subject to unintended and costly compliance requirements that would have been impracticable, according to a letter from the **American Securitization Forum**.

"The CFTC has addressed 90-95% of our concerns related to the commodity pool definition with the first two no-action letters," said **Tom Deutsch**, executive director of the ASF. "We expect there may be one additional no-action letter to cover the last five or 10%."

Industry professionals see Freddie and Fannie's proposed risk-sharing deals as vitally important to restarting a private label mortgage-backed securities market by getting mortgage risk off the government's balance sheet and helping to establish market pricing for non-agency MBS. The GSEs were reportedly scheduled to begin selling such bonds in September, but they never materialized, owing to the CFTCs proposed rules. "The proposed use of derivatives under Fannie and Freddie's risk-sharing deals do not have a clear exemption from the CFTC," said Deutsch.

**Joseph Buonanno**, head of the derivatives group at **Huntington & Williams**, said legacy synthetic securitizations issued before Oct. 12 have generally been given an exemption, but not such deals issued after that date. "In order to facilitate credit risk management by financial institutions, there would need to be no-action letter relief for synthetics issued by banks seeking credit protection on assets owned, for example," as well as synthetics structured for clients hedging short positions and sold to investors looking for long positions on certain credits.

Other concerns include the CFTC's guideline stating securitizations that use swaps to obtain "commercially unreasonable" credit enhancement are not exempt from the commodity pool definition. The CFTC's Dec. 7 letter stated that swaps are only to be used for credit enhancement "to the extent contemplated by Item 1114 of Regulation AB."

"There's nothing in Reg. AB that prohibits any level of credit support," said **Charles Sweet**, partner at **Bingham McCutchen**. That language could cause heartburn to structurers. Securitization lawyers are unhappy with some of the CFTC's language because "it is principles-based, not rules-based," Sweet added. But "in terms of what the industry was looking for, you're almost all the way there."

"Until people know where the convoy is headed, [issuers] likely will not be be too aggressive with their interpretation of the guidelines," Buonanno said. The ASF is also looking to get exemptions from certain requirements for securitizations that would be considered commodity pools. As of now, securitization trusts not exempt would have to pass the Series 3 exam and provide periodical audited financial statements, according to Deutsch, who said such requirements would be inappropriate to securitizations.

Officials at Freddie, Fannie and the CFTC either declined to comment or did not respond to requests for comment.

  

## Compliance Clinic

# FINRA Arbitration Choice: Considerations For IAs

***By Sean Coughlin, Angela Turiano and Alex Sabo of Bressler, Amery & Ross***


*Sean Coughlin*


*Angela Turiano*


*Alex Sabo*

Traditionally, disagreements between registered investment advisers and their customers have been resolved in state and federal courts or before arbitration forums such as **JAMs** or the **American Arbitration Association**. But on Oct. 25, 2012, the **Financial Industry Regulatory Authority** published guidance on its website regarding its decision to open up its forum to disputes between customers and IAs, explaining that it had received inquiries from counsel representing both investors and IAs about the availability of FINRA's arbitration and mediation forums.

While FINRA arbitration is effectively mandated by pre-dispute arbitration clauses in customer agreements with broker/dealers and their registered representatives, the forum will be entirely voluntary for IAs. All parties must agree to arbitrate through the self-regulatory organization after a dispute has arisen. Accordingly, IAs must decide whether it is prudent to take advantage of FINRA's recent expansion.

At first blush, FINRA's dispute resolution forum seems an attractive alternative to a court proceeding or other arbitration forums as it offers parties a quicker and more cost effective way to resolve disputes. However, there are potential pitfalls, many of which may be to the detriment of IAs. These pitfalls include incompatible discovery procedures, the limited ability to make dispositive motions, arbitrators' ability to apply differing legal standards and the potential for increased litigation.

### Discovery

Discovery in the FINRA arbitration process is governed by the SRO's Discovery Guide, which sets production lists specifying documents that should be produced in all customer disputes. For the respondent firm, these documents include all account record information listing suitability criteria and all correspondence sent to the customer (see box).

The Discovery Guide details a separate set of document production lists for public customers. During the initial prehearing conference with the parties, FINRA arbitrators instruct the parties that the documents listed in the guide are "presumed discoverable" and "should be exchanged automatically." Although arbitrators retain their flexibility in the discovery process in that they can order the production of documents not described in the lists, arbitration panels, as a general rule, rely heavily on the lists in resolving discovery disputes and issuing discovery orders.

As of yet, FINRA has not indicated that it intends to formulate a separate set of discovery guidelines for IA disputes. Thus, the Discovery Guide could present some complications for IAs. The SRO went to great lengths to give guidance to B/Ds regarding documents it considers discoverable in customer disputes. As a result, B/Ds have implemented procedures and document retention policies that are consistent with FINRA discovery rules and ensure that "presumptively discoverable" documents are easily obtainable and/or readily available. IAs will not have this advantage and arbitration panels may expect them to have the same or similar policies and procedures in place as B/Ds, and hold them accountable if they are not able to produce the requisite materials in discovery.

Another issue to consider is the streamlined discovery available in FINRA arbitrations. While minimizing discovery reduces costs, it also means that parties do not enjoy the same broad access to relevant information provided through discovery available in court and other arbitration forums. An arbitration panel with a restrictive view of discovery could therefore hamper the parties' ability to prepare their cases. For example, FINRA discovery rules discourage the use of depositions except in very limited circumstances.

In addition, standard interrogatories are generally not permitted in arbitration. Parties may propound requests for information, but these are limited to the identification of individuals, entities and time periods relating to the dispute and do not provide the same level of detail as a traditional interrogatory. Of course, because both claimant and respondent are subject to the same discovery rules, the IA would not, arguably, be disadvantaged disproportionately.

### Dispositive Motions

There is also the issue of dispositive motions and the extremely limited circumstances in which they can be made in the FINRA forum. Rule 12504 of the FINRA Code of Arbitration Procedure forbids dismissal motions before the case in chief is concluded, with either of two exceptions:

- The non-moving party previously released the claims in dispute with a signed settlement or agreement or release
- The moving party was not associated with the account(s), security(ies) or conduct at issue

In all other instances, regardless of merit, the claimant will be allowed to proceed to a hearing and present a case, before the panel considers a motion to dismiss. This may lead to increased legal costs and decreased productivity in that the IA's employees will have to appear at the hearing and provide testimony.

### Suitability

In addition, IAs should consider recent changes to FINRA rules concerning investor suitability and standard of care to customers, and whether arbitration panels will be able to distinguish between the different standards that apply under federal law for IAs as opposed to B/Ds. There could be confusion among active FINRA arbitrators regarding which standards apply in any given arbitration. This potential problem may be exacerbated by the inclusion of so-called "all-public panels" in FINRA arbitrations.

Traditionally, FINRA arbitration panels were comprised of two "public arbitrators" and one individual with ties to the securities industry (a "non-public" arbitrator). Beginning in February 2011, claimants with claims over $100,000 could elect to proceed with an all-public panel and strike all of the potential non-public arbitrators. Notably, FINRA only requires that its arbitrators have "at least five years of full-time, paid business or professional experience" and at least two years of "college level credits" to apply to serve as an arbitrator. As a result, the dispute could be heard by three individuals who lack any securities background or legal experience.

**CHECKLIST:**

**Document Production**

*FINRA's Discovery Guide requires that respondent firms in arbitrations produce documents including:*

- All account record information listing suitability criteria
- All correspondence sent to the customer
- Documents evidencing any investment or trading strategies used or recommended and the supervisory review of such strategies
- Documents or information the professional relied on in making the recommendation
- Notes and calendar entries
- Internal correspondence concerning the customer and supervision of the accounts
- Telephone recordings and records
- Exception and other supervisory reports
- Copies of the professional's manuals and updates
- Investigations conducted internally or by state/federal agencies
- Any analysis prepared about the performance of the accounts
- Records relating to compensation

### Exposure

Lastly, IAs should seriously consider their exposure to potential claims should they elect to use FINRA's arbitration forum. Certainly, lower costs, easier access and expedited processes will attract more potential litigants. Indeed, investor law firms have already begun to use FINRA's forum expansion to solicit additional customers to initiate law suits with advertisements making statements such as, "If you are a victim of securities fraud because of the actions of your IA and you could not afford it before due to the high costs of other arbitration forums or court proceedings…" A simple Internet search with the terms "investment adviser" and "arbitration" will result in multiple links to such solicitations—results that will likely increase in number over time.

### Weighing A Decision

Although FINRA arbitration is more cost effective and efficient than court proceedings or other arbitration forums, there are potential hazards to proceeding with the SRO as an elected forum. All of this being said, there is the issue of FINRA's lack of authority over IAs to consider. Although FINRA has been lobbying for years to expand its reach, its oversight remains limited to B/Ds, while IAs historically have fallen under the oversight of the **Securities and Exchange Commission**. FINRA does not regulate IAs, and therefore lacks the authority to suspend an IA for failure to pay FINRA fees or satisfy a monetary award. This is certainly something an IA may consider in deciding how to proceed.

Ultimately, there is no easy answer to the question: "To FINRA or not to FINRA?" IAs should weigh the pros and cons carefully before agreeing to arbitrate through this alternate dispute resolution forum.

***Sean Coughlin*** *and* ***Angela Turiano*** *are members of* ***Bressler, Amery & Ross*** *in New York.* ***Alex Sabo*** *is a member in Bressler's Fort Lauderdale, Fla., office. Associate (awaiting admission)* ***Diana Mahoney*** *in the firm's New York office assisted with this article.*



  

## Rule Docket

*Compliance Intelligence* presents an at-a-glance listing of key upcoming regulatory developments. The chart is designed so you can see immediately what you need to do, and when, over the coming weeks—whether that's get your voice heard about a proposal or get your firm ready to comply. If you have any comments, questions or would like to notify us of an upcoming rule change please contact Managing Editor **Ben Maiden** at (212) 224-3281 or bmaiden@iiintelligence.com.

| Regulator | Region | Topic | Details | Upcoming Deadline(s) |
|---|---|---|---|---|
| Commodity Futures Trading Commission | North America | Futures commission merchants protections | Requested comment on a proposal to adopt new regulations and amend existing regulations to require enhanced customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosures and auditing and examination programs for futures commission merchants. The proposal also addresses certain related issues concerning derivatives clearing organizations and chief compliance officers. | Comments due Jan. 14. |
| Financial Services Authority (U.K.) | Europe | Benchmarks | Proposed new rules and regulations for financial benchmarks that follow the recommendations of the Wheatley Review of the London interbank offered rate. The proposals include requiring benchmark administrators to corroborate submissions and monitor for an suspicious activity. | Comments due Jan. 16. |
| Financial Industry Regulatory Authority | North America | General counsel | Filed a proposal with the SEC to amend Rule 9120 (definitions) to add the term chief legal officer to the definition of general counsel. | Comments due Jan. 16. |
| FINRA | North America | Continuing education program | Filed a proposal with the SEC to amend NASD Rule 1022 (categories of principal registration) and NASD Rule 1032 (categories of representative registration) to extend the deadline by which eligible registrants must complete a firm-element continuing education requirement to engage in a security futures business to Dec. 31, 2015, or one business day prior to the date a revised examination that includes security futures is offered. | Comments due Jan. 16. |
| FINRA | North America | Security-based swaps | Filed a proposal with the SEC to extend the expiration date of Rule 0180 (application of rules to security-based swaps) to July 17. | Comments due Jan. 16. |

## Regulator Guidance Hub

*Compliance Intelligence* presents listings of key recent no-action letters, reports and other guidance from the regulators impacting brokerages and investment management shops. Make sure you have the latest advice and insight. You can find quick links to each of these documents by going to Complianceintel.com. If you have any comments, questions or would like to notify us of any upcoming guidance please contact Managing Editor **Ben Maiden** at (212) 224-3281 or bmaiden@iiintelligence.com.

| Regulator | Date Released | Topic |
|---|---|---|
| Securities and Exchange Commission | Dec. 2012 | Released no-action letter regarding regulatory issues related to the lack of access to physical securities located at the Depository Trust & Clearing Corp.'s vault. |
| Commodity Futures Trading Commission | Dec. 2012 | Division of Swap Dealer and Intermediary Oversight issued no-action letter providing registration relief to certain introducing brokers and commodity trading advisers involved in swaps activities. |
| CFTC | Dec. 2012 | Division of Swap Dealer and Intermediary Oversight issued no-action letter for certain persons required to register pursuant to recent changes to Commission regulations. |
| CFTC | Dec. 2012 | Division of Swap Dealer and Intermediary Oversight issued no-action letter for operators of investment pools that invest in legacy securitization vehicles. |
| CFTC | Dec. 2012 | Division of Market Oversight provided swap dealers with swap data reporting relief. |
| CFTC | Dec. 2012 | Division of Market Oversight issued time-limited, no-action relief from the reporting of certain non-reporting counterparty information pursuant to parts 45 and 46. |
| CFTC | Dec. 2012 | Office of the General Counsel issued time-limited, no-action relief for compo equity total return swaps. |
| CFTC | Dec. 2012 | CFTC approved exemptive order on cross-border application of the swaps provisions of the Dodd-Frank Act. |
| CFTC | Dec. 2012 | Division of Swap Dealer and Intermediary Oversight issued no-action relief regarding the treatment of swap transactions arising from multilateral portfolio compression exercises for the purposes of making calculations under the swap dealer definition. |
| CFTC | Dec. 2012 | Division of Swap Dealer and Intermediary Oversight issued no-action relief for certain U.S. banks wholly owned by non-U.S. swap dealers for the purposes of making calculations under the swap dealer definition. |
| CFTC | Dec. 2012 | Division of Swap Dealer and Intermediary Oversight issued time-limited no-action relief regarding the treatment of swap transactions by persons engaging in floor trader activities for the purposes of making calculations under the swap dealer definition. |
| CFTC | Dec. 2012 | Division of Market Oversight issued time-limited, no-action relief for swap dealers and major swap participants from the reporting provisions of Part 45 for credit default swaps clearing-related swaps. |
| Financial Industry Regulatory Authority | Jan. 2013 | Released guidance on new rules governing communications with the public |
| Municipal Securities Rulemaking Board | Jan. 2013 | Published its 2012 annual report, which highlights the organization's activities and provides financial highlights for the fiscal year that ended Sept. 30, 2012. |
| Investment Industry Regulatory Organization of Canada | Jan. 2013 | Issued a guidance notice for comment regarding the use of business titles and financial designations. |
| IIROC | Jan. 2013 | Published study of high order-to-trade activity on Canada's equity markets. |
| Financial Services Authority (U.K.) | Jan. 2013 | Published paper consulting on the Prudential Regulation Authority's approach to enforcement. |

# IM CCOs *(Continued from page 1)*

## Presence Exams

More than 1,500 private fund advisers registered with the SEC last year under the Dodd-Frank Act. Among the many compliance hurdles they face this year is a first round of examinations, with the SEC's Office of Compliance Inspections and Examinations having developed a methodology aimed specifically at newly enrolled shops—the agency's so-called "presence exams" (CI, 10/18).

CCOs at newly enrolled private advisers should pay close attention to the five areas OCIE has singled out for review in a letter describing presence exams, **K&L Gates** Partner **Kay Gordon** told *CI*. The topics highlighted by the Commission are: marketing, portfolio management, conflicts of interest, safety of client assets and valuation.

"The SEC now requires more disclosure about asset valuation, including whether assets have been valued by an independent third party," Gordon said. "Advisers should pay special attention to assets that are not publicly traded or assets that are thinly traded, particularly when their advisory fees are based on the values assigned to such assets or when investors are admitted or redeemed on the basis of such values," she added. "Often the valuation of those assets is dependent on the information that a fund manager provides, which the SEC views as a conflict of interest."

Private advisers also need to be sure they understand what constitutes having custody of client assets, Gordon said. Examiners will be checking to see that new registrants are taking specific steps to guard against the theft or loss of client assets over which they have custody, according to the Commission's letter.

**ON YOUR RADAR**

*Investment management CCOs will need to keep an eye on issues such as:*

- Presence exams
- Marketing materials
- Political contributions
- CPO registrant rules

Examiners want to see that new registrants are fostering a culture of compliance and developing programs tailored to their specific firm rather than adopting "off-the-shelf" procedures, OCIE Director **Carlo di Florio** told *CI* last month (CI, 12/13).

## Marketing

Compliance officers at investment advisers in general, not just new private adviser registrants, have a range of other challenges this year. Among these, CCOs should take a close look at fund marketing materials and look to recent SEC enforcement actions for guidance in that area, according to **Steven Yadegari**, CCO and general counsel of New York-based **Cramer Rosenthal McGlynn**.

"One of the constant challenges for [C/Os] is trying to identify what could be isolated or inadvertent misstatements and then reducing the possibility that those things occur and having a structure in place to not only prevent them from happening, but to pick up on them when they do," Yadegari told *CI*.

He highlighted the SEC's recently settled administrative proceeding against Stamford, Conn.-based **Aladdin Capital Management** as an example from which C/Os could learn. The Commission alleged that Aladdin marketed to clients two collateralized debt obligations by stating that it would co-invest in the same CDOs. But the firm did not co-invest, or have "skin in the game," as it represented, the SEC said. Aladdin was fined $450,000 and required to disgorge $900,000 plus $268,831 in interest. The firm settled without admitting or denying wrongdoing. Aladdin Founder and Shareholder **Amin Aladin** said in a statement last month, "We are pleased to settle a legacy issue concerning the placement activities of Aladdin's former employees. We have worked hard with the SEC over the past two and a half years to try to resolve this issue, and we are happy to be able to move forward. We would like to thank the SEC for its professionalism and courtesy throughout this process."

> **There is a lot more to the political contribution regulations and they're a lot more complex than people realize.**
>
> **—Steven Felsenthal, Millburn Ridgefield Corp.**

"If you're making the statement that you are investing alongside your clients in all investments you better satisfy yourself that that's absolutely true," Yadegari said. "If it's only some of the time you have an obligation to say it's only some of the time."

## Political Contributions

The rules governing political contributions are another area that merits attention from CCOs in 2013, according to **Millburn Ridgefield Corp.** CCO and General Counsel **Steven Felsenthal**. "There is a lot more to the political contribution regulations and they're a lot more complex than people realize," Felsenthal told *CI*. "A lot of people design programs just to meet federal rules, but state rules complicate regulations regarding both pay-to-play and lobbying registration." A 2010 SEC rule placed limits on the political contributions that investment advisers and certain employees could make.

In addition, the rules in individual states may set different threshold levels for contributions for asset managers with connections to government investors, Felsenthal said. "The federal rules are mostly limited in application to sales people and senior officers, while the state rules could apply to anybody."

## CFTC Rule 1101

A number of private advisers will also find themselves under **Commodity Futures Trading Commission** oversight this year, after the regulator required certain firms to register as commodity pool operators.

New registrants will need to pay close attention to several of the specific rules of the CFTC and the **National Futures**

  

**Association**, the self-regulatory organization for the futures industry. For example, C/Os should be careful that their shops adhere to NFA Bylaw 1101, which prohibits members from doing business with non-members who are supposed to be registered but aren't, said **Willkie Farr & Gallagher** Partner **Rita Molesworth**.

"That bylaw is a challenge, especially for managers of large funds that now have to register as CPOs and have hundreds or thousands of investors," Molesworth said. "So if some of those investors are themselves required to have a registered CPO it can be difficult for advisers to verify that they are in compliance."

NFA provided temporary relief in a Dec. 19 notice to members, informing them that they would be considered in compliance with Bylaw 1101 if the CPO ensures the proper registration of any futures commission merchants through which the fund makes commodity interest transactions and of any sub-advisers that help manage the fund. The adviser to a registered fund won't have to check the registration status of each of the fund's underlying investors until the NFA provides further guidance, the notice stated.

Meanwhile, a lot of fund managers have been sending questionnaires to their clients over the past several months, trying to verify their registration or exemption status, Molesworth said. "It's something that catches a lot of people by surprise."

***—Peter Rawlings***

## Private Advisers *(Continued from page 1)*

CCOs or outsourcing compliance work, industry professionals said.

"The growth of compliance teams is not what you think it would be," said **Stuart Rosenthal**, managing director of **Rosenthal Recruiting**. "It's a business decision first. The majority of firms are outsourcing when they can or hiring a junior person." Many firms did not make much money in the last year, so it's difficult for them to commit to devoting additional resources to compliance programs, the CCO of a New York-based fund firm with more than $1 billion AUM told ***CI***.

Outsourcing is allowed under the SEC's compliance rule. But **Mavis Kelly**, an assistant director with the agency's Office of Compliance Inspections and Examinations, last year warned that new registrants outsourcing their entire compliance program may attract the scrutiny of examiners, particularly those whose funds invest in mostly complex, thinly traded or difficult-to-value instruments, or those with potentially more serious conflicts

of interest (CI, 4/5). Some smaller shops have opted to limit headcount by hiring an outside firm to create and manage new procedures.

Some advisers that have hired full-time compliance staffers have chosen to target more junior candidates, so as to limit the initial expense, Rosenthal said. He described one mid-sized PE fund firm, looking to fill its first dedicated CCO position, that was willing to hire someone with as little as three years' experience. "They were determined to stick with their budget of between $150,000 and $200,000," he said, adding that this was well below the salary that professionals with five or 10 years of experience might expect.

Roughly half of firms seem to have chosen not to hire a CCO immediately, with the decision depending on factors such as the structure of the management team, the firm's size and strategy, according to **Justin Mandel**, managing director with recruitment firm **JW Michaels**. "They don't want to take too much risk by hiring someone as a CCO right away, so oftentimes they'll hire someone as a deputy."

"The reality is that it's another infrastructure cost," said **Julie Goldberg Preng**, a managing director at recruiters **Korn/Ferry International**. "This is all new for a lot of firms that they have to get to this level of infrastructure on this function, so I think people who are making hiring decisions are thinking carefully about how they want to do it."

Non-CCO positions can still require professionals with significant experience, however. Mandel cited one technology-focused PE firm as having recently hired a deputy CCO who had spent several years at a large law firm before working for nearly a decade at the SEC. The salary for the position was between $200,000 and $300,000. An ideal CCO candidate might have a similar background, and would also have experience working in-house doing compliance work for a fund, Mandel said, adding that the salary for newly appointed CCOs might range from $400,000 to $600,000.

"While I wouldn't say right now [firms are] expanding in a large scale way, what I can say is that we've had conversations with clients where this is very much a topic of discussion," said Korn/Ferry's Preng. "Eventually there's a tipping point where you do a cost-benefit analysis" and decide hiring in-house compliance staff is worthwhile, she said. "It's potentially just too soon to be able to see a wholesale expansion of the function in terms of head count."

***—Peter Rawlings***

## They Said It

*"I don't see a ton of hiring going on and I haven't seen that many new positions, which surprises me."*—**Steven Felsenthal**, chief compliance officer and general counsel at **Millburn Ridgefield Corp.**, on the unexpectedly slow pace of compliance recruitment among newly **Securities and Exchange Commission**-registered private advisers (see story, page 1).

## BAR STOOL

### Resolution: Let's Get Along

The New Year finds many people making resolutions: to lose weight, quit smoking or perhaps cut down on that unhealthy insider trading habit. And it can only be hoped that—whatever your politics—Congress resolves to work together more fruitfully in 2013. The effects of continued battles over the fiscal cliff and debt ceiling, for example, will be felt everywhere, including financial regulation. For a start, it leaves questions over future budgets of key agencies, hampering plans for initiatives aimed at rebuilding investor confidence.

Meanwhile, regulators' ability to bring wrongdoers to justice cannot be helped by a lack of appointed judges and any court system underfunding. In his recent annual report, U.S. Chief Justice **John Roberts** pleaded with Congress and the White House to "be especially attentive to the needs of the Judicial Branch and provide resources necessary for its operations." Roberts also pointed out that 27 of the court vacancies outstanding at the end of 2012 were designated "judicial emergencies." **Reuters** reported recently that President **Barack Obama** has won congressional confirmation of 172 nominees to the federal bench, compared with 205 secured over the same time frame by his predecessor, **George W. Bush**, and that the number of federal court vacancies has risen from 55 when Obama took office to 75.

Having an effective regulatory regime isn't all about money, and it isn't all about having enough judges. But vacancies and funding worries don't help. Politics aside, moving toward certainty and a full bench can only increase the chances of effective supervision.

## One Year Ago In Compliance Reporter

Broker/dealers and the **Securities Industry and Financial Markets Association** devised a standardized certificate to help them meet their compliance obligations under the **Financial Industry Regulatory Authority**'s suitability rule, which was due to go into effect July 9. [FINRA last month issued new guidance on the rule in which it gave comfort to firms on the issue of whether casual conversations with potential clients could be construed as creating suitability obligations (see story, page 3).]

## Five Years Ago

Attorneys were predicting that a **Financial Industry Regulatory Authority** probe into broker/dealers' sales of collateralized mortgage obligations was likely to uncover problems and lead to enforcement actions. [FINRA continues to focus on complex products, particularly their sale to retail customers (CI, 12/21).]