INVESTMENT MANAGEMENT
LEGAL+REGULATORY UPDATE

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IN THIS ISSUE

REGULATION

Long-Awaited Money Market Fund Rules Adopted

On July 28, 2014, a divided SEC adopted rules that will require floating net asset values (NAVs) for institutional money market funds and give most money market funds the discretion to impose liquidity fees and gates. The 3-2 vote, which closes the latest tumultuous chapter of money market fund regulatory reform, will fundamentally change the way that most money market funds operate.

Importantly, the floating NAV requirement will not apply to retail money market funds (i.e., those sold only to investors who are natural persons) or to any government money market funds (whether or not they are institutional funds).

The new rules will increase the responsibility of money market fund boards. Fund boards will be authorized to temporarily "gate" redemptions and impose redemption fees of up to two percent when a fund's weekly liquidity falls below 30 percent of its total assets. If a fund's weekly liquidity drops to 10 percent, the fund will be required to impose a one percent redemption fee, unless the fund's board determines otherwise. In that case, the board can also impose a redemption fee of up to two percent.

The rules will also impose additional disclosure, reporting, and stress-testing requirements.

According to Chairman Mary Jo White, the new rules strike a balance to address two principal risks that grew out of the 2008 global financial crisis, namely:

- The "first mover advantage," which encourages investors to be the first to redeem so they can receive the fixed $1 NAV even if the market-based NAV is less than $1 per share; and
- The fear of widespread investor runs and the "potential for contagion from one fund," which can result in heavy redemptions.

Commissioners Kara M. Stein and Michael S. Piwowar voted against the proposals.

In tandem with the Commission's new rules, the Department of the Treasury and the Internal Revenue Service are expected to provide tax relief that will "eliminate significant costs" created by the floating NAV requirements. New IRS rules will let money market fund investors determine gains and losses on a net basis over a year, rather than requiring investors to track individual transactions. Also, the IRS will ease the "wash sale" rules for losses on shares of floating NAV money market funds.

The Commission also proposed amendments to Rule 2a-7 that would remove references to credit ratings, as required by the Dodd-Frank Act. If the amendments are adopted, money market fund boards must determine that portfolio securities have "minimal credit risk" instead of relying in part on objective standards, such as credit ratings. The Commission also proposed a rule that would exempt money market funds from the confirmation requirements of Rule 10b-10 of the Securities Exchange Act of 1934.

Imposing floating NAVs, redemption fees, and gates must be complete by October 14, 2016. The effective date of new reporting requirements is July 14, 2015 and the new diversification and stress test requirements become effective April 16, 2016.

SEC Staff Offers Guidance Regarding Investment Advisers and Proxy Advisory Firms

The SEC's Division of Investment Management and Division of Corporation Finance published joint guidance on June 30, 2014, regarding investment advisers' responsibilities when voting client proxies. The guidance also addressed two exemptions from the federal proxy rules that are often relied upon by proxy advisory firms.

The staff noted that the guidance may require investment advisers and proxy advisory firms to make changes to their systems and processes. The staff stated its expectation that these changes should be made promptly, "but in any event in advance of next year's proxy season."

The guidance reiterated an investment adviser's fiduciary duty to cast proxy votes in a manner that is in accordance with clients' best interests and the adviser's proxy voting procedures. The staff's guidance provided examples of how advisers can demonstrate compliance with this obligation and made clear that advisers and their clients may agree by contract on the manner in which proxy voting authority will be delegated.

The guidance suggested that investment advisers should establish and implement measures reasonably designed to identify and address conflicts that can arise on an ongoing basis. Advisers should also implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of proxy advisory firms and to ensure that the investment adviser, acting through a proxy advisory firm, continues to vote proxies in the best interests of its clients.

The guidance also addressed the application of the proxy rules to proxy advisory firms. In general, the staff said, proxy advisory firms are subject to federal proxy rules because their advice constitutes a "solicitation" of proxies. However, proxy advisory firms are exempt from the information and filing requirements of the proxy rules if they comply with the requirements of exemptions contained in Rule 14a-2(b).

Among other things, Rule 14a-2(b) exempts persons who do not seek the power to act as a proxy for a security holder, such as proxy advisory firms that limit their activities to distributing reports containing recommendations. The Rule also exempts persons that furnish proxy voting advice to another person with whom a business relationship exists, subject to conditions outlined in Rule 14a-2(b)(3).

For more information on the staff's guidance, please see our recent client alert.

SEC Staff Closes Loophole on BDC Asset Coverage Requirements

In a guidance update published on June 30, 2014, the staff of the SEC's Division of Investment Management closed a loophole that allowed business development companies (BDCs) with wholly owned Small Business Investment Company (SBIC) subsidiaries to avoid meeting asset coverage requirements when the SBIC subsidiaries issue debt that is not guaranteed by the Small Business Administration (SBA).

Sections 18(a) and 61(a) of the 1940 Act generally require BDCs to meet asset coverage requirements when they issue "senior securities," including debt instruments. A BDC may be deemed an indirect issuer of any class of "senior security" issued by its direct or indirect wholly owned SBIC subsidiaries.

The SEC has regularly granted BDCs limited exemptive relief from these asset coverage requirements, enabling BDCs to treat certain indebtedness issued by their wholly owned SBIC subsidiaries as indebtedness not represented by senior securities for purposes of determining the BDC's consolidated asset coverage. The SEC exemptive orders are, in part, based upon the representation that SBIC subsidiaries are subject to the SBA's regulation of leverage.

The staff said that it learned that some BDCs have sought to rely on this limited relief in connection with SBICs that have not issued indebtedness that is held or guaranteed by the SBA. The staff took issue with this approach, noting that the requirement that such indebtedness be held or guaranteed by the SBA is implicit in the staff's orders. When an SBIC subsidiary issues debt that is not backed by the SBA, the subsidiary is not subject to the full oversight of the SBA, and thus the protections of Section 18(a) are required.

Going forward, the staff will require that BDC applications for relief from the Section 18 asset coverage requirements include a condition that relief will be granted only if indebtedness issued by wholly owned SBIC subsidiaries is held by or guaranteed by the SBA.

SEC Staff Warns Against "Disclosure Creep"

The staff of the SEC's Division of Investment Management warned against "disclosure creep" invading mutual fund prospectuses in regulatory guidance posted in June 2014.

The staff's guidance breaks no new ground. Rather, it provides a concise primer of Form N-1A's layered prospectus disclosure requirements. Among other things, the guidance reminds registrants to:

- limit the Summary Section to prescribed disclosures;
- avoid unnecessary and confusing cross-references;
- clearly identify principal investment strategies versus non-principal strategies; and
- generally be mindful of the SEC's plain English requirements.

The staff reminded mutual funds and their service providers that registrants must place disclosures in the right place. Lengthy disclosures about non-principal strategies belong in the statement of additional information, not the Summary Prospectus. In any event, the disclosures must comply with the SEC's plain English requirements.

Registrants should take note that they may be found liable for disclosing too much in the wrong places.

SEC Staff: Measure Percentage Ownership by Fund, Not by Complex

In a recent guidance update, the SEC's Division of Investment Management said that series mutual funds are individual investment companies for purposes of compliance with certain investor protections, including the 1940 Act's restrictions on principal transactions.

Section 17(a) of the 1940 Act generally prohibits an "affiliated person" of a mutual fund, or an affiliated person of an affiliated person (a so-called "second-tier affiliate") from selling any security or other property to the fund. This prohibition can cause compliance headaches when evaluating certain transactions such as repos and swaps.

Here's why: an affiliated person includes any 5 percent shareholder of a mutual fund, so that any financial institution owning 5 percent or more of the fund cannot be a repo or swap counterparty. An affiliated person of that financial institution (the second-tier affiliate) also would be prohibited from acting as a counterparty. Small funds, in particular, can violate Section 17(a) if a repo or swap counterparty, or its affiliate, owns a relatively small position in a fund. To avoid this potential foot fault, funds must monitor ownership and affiliation relationships that may be difficult to track.

Left unsaid in this regulatory guidance is that mutual funds cannot, when measuring 5 percent ownership, take into consideration the entire shareholder base of the corporation or trust that serves as the "umbrella" for a series fund. If a counterparty measured its ownership of a series fund's shares against the total assets of all funds under the umbrella trust, then the counterparty is much less likely to be considered an affiliated person because its percentage of ownership of the entire complex would be much smaller.

In light of this guidance, advisers and fund directors should review their compliance policies and procedures to ensure they are adequate to identify first- and second-tier affiliated persons.

SEC Launches Exam Initiative for Newly Registered Municipal Advisers

The SEC is not wasting any time making sure that newly registered municipal advisers are introduced to their regulator. On August 19, 2014, the SEC announced a two-year examination initiative for municipal advisers that registered with the SEC in accordance with final municipal adviser rules that became effective on July 1, 2014. OCIE's National Examination Program (NEP) stated that the initiative will include "focused, risk-based" examinations of municipal advisers registered with the SEC but not with FINRA.

The examinations will address municipal advisers' compliance with both the final SEC municipal adviser rules and Municipal Securities Rulemaking Board rules as they become final.

The examination initiative will proceed in three phases: (1) an "engagement" phase, during which the NEP will reach out to newly registered municipal advisers to inform them of their obligations under the Dodd-Frank Act and related rules; (2) an "examination" phase, during which the NEP staff will review selected municipal advisers' compliance programs in one or more identified risk areas; and (3) an "informing policy" phase during which the NEP will report its observations to the SEC. OCIE said that the particular risk areas that may be included in its examinations will include registration, fiduciary duty, disclosure, fair dealing, supervision, books and records, and training/qualifications.

The NEP noted that the results of OCIE's examinations are typically used by the SEC "to inform rule-making initiatives, to identify and monitor risks, to improve industry practices and to pursue misconduct." In other words, municipal advisers should expect that these examinations will result in additional SEC guidance to municipal advisers regarding how they conduct their businesses.

At this time, there is no indication of how examination participants will be selected, but OCIE has announced that it plans to examine a "significant percentage" of new municipal advisers. Newly registered municipal advisers should plan to participate in OCIE's compliance outreach program, which will take place later this year, to learn about compliance issues and practices, and to understand what to expect from an OCIE examination.

U.S. House Votes to Reauthorize the CFTC and Exclude Most RICs from CPO and CTA Requirements

On June 24, 2014, the U.S. House of Representatives passed a version of the CFTC reauthorization bill, H.R. 4413, that would exclude investment advisers to registered investment companies (RICs) from the definitions

of commodity pool operator (CPO) and commodity trading adviser (CTA) if they limit their advice and trading activity to "financial commodity interests."

H.R. 4413 (the Customer Protection and End User Relief Act) included an amendment introduced by Rep. Garrett of New Jersey. The Garrett Amendment, as included in the bill, defines financial commodity interests as futures contracts, options on futures contracts, and swaps involving non-traditional commodities (exempt commodities, such as natural resources and agricultural commodities, are excluded from the definition).

If enacted, the bill will exempt most investment advisers to RICs from CPO and CTA registration and other requirements, including the CFTC's substituted compliance regime. Substituted compliance generally permits investment advisers to RICs to comply with SEC regulatory requirements in place of comparable CFTC requirements (see our related client alert). While intended to relieve some of the burdens imposed by duplicative CFTC and SEC regulations, substituted compliance was viewed by many as insufficient, since it did not cover requirements imposed by the National Futures Association or the CFTC's rules governing commodity interest trading activities.

The Garrett Amendment will not alter the SEC's regulatory oversight or enforcement authority over RICs, nor will it affect the CFTC's jurisdiction over RICs that trade in physical commodities.

It is too early to predict whether the Senate will approve the bill that includes the Garrett Amendment.

Banking Regulators: Exit Fees for Bond Mutual Funds?

Should federal regulators impose exit fees on bond funds? Officials at the Board of Governors of the Federal Reserve may think so.

The *Financial Times* reported on June 16, 2014, that Fed officials have discussed whether regulators should impose exit fees on bond funds to avert a potential run by investors. The Fed apparently is concerned that bond funds are becoming "shadow banks" because investors can redeem their shares on any day, even though funds may face difficulties in selling off assets to meet redemptions in a liquidity crunch.

The FT reported that Jeremy Stein, who recently stepped down as a Fed governor, implied that bond mutual funds resemble banks and "may be the essence of shadow banking. . . ." The discussions at the Fed were at a senior level and have not yet developed into a formal policy.

Commissioner Piwowar Slams "Dodd-Frank Politburo" for Overstepping Authority

In a speech on July 15, 2014, SEC Commissioner Michael S. Piwowar expressed his views about the Financial Stability Oversight Council (FSOC) operating in secrecy as it tries to expand its regulation of financial institutions and the capital markets.

Commissioner Piwowar opened his speech with a number of phrases about FSOC, calling it, among other things:

- The Firing Squad on Capitalism
- The Vast Left Wing Conspiracy to Hinder Capital Formation
- The Bully Pulpit of Failed Prudential Regulators
- The Dodd-Frank Politburo
- The Modern-Day Star Chamber
- The Unaccountable Capital Markets Death Panel

But how does Commissioner Piwowar really feel about FSOC?

FSOC members include the chairs of various commissions and boards (including the SEC), but not the individual commissioners or board members. Commissioner Piwowar complained that FSOC rebuffed his attempt to attend its meetings as a non-participating guest, which, he said, was disappointing but not surprising. But, he said, FSOC also shut out Rep. Scott Garrett, the chairman of the Subcommittee on Capital Markets and Government-Sponsored Enterprises, from FSOC meetings. He called this action "shocking, appalling and downright insubordinate."

Commissioner Piwowar accused FSOC, led by the "alpha dog" Board of Governors of the Fed, of starting a turf war by asserting broad regulatory authority over matters that are exclusively in the SEC's jurisdiction,

SPOTLIGHT ON BDCS

BDC Trend, or Too Early to Tell?

Although many BDCs have been trading below NAV recently, there have been a couple of managers to public BDCs that themselves have completed or are seeking to complete initial public offerings. The most recent two, Medley Management and Fifth Street Asset Management, follow the model set earlier in the year by Ares Management. These management companies are structuring their initial public offerings as "up-C" transactions wherein the public issuer is a C-corporation with a dual class structure. The Class A shares are offered to the public in the IPO, and the Class B shares are retained by the legacy holders. The public issuer remains a holding company only with operations conducted by a limited liability company or other tax pass-through vehicle. This may signal the beginning of a trend for managers of publicly traded BDCs; however, it is not yet clear how investors will react to these transactions, which may be perceived as complex and giving rise to potential or actual conflicts of interest.

thus compromising the SEC's mission to protect investors; maintain fair, orderly, and efficient markets; and promote capital formation.

The Commissioner called for more transparency at FSOC and said he supported efforts by Rep. Garrett to make FSOC "accountable and transparent."

The Commissioner, however, stopped short of accusing FSOC of trying to regulate the SEC as a Systemically Important Financial Institution.

ENFORCEMENT + LITIGATION

Paying for Playing: SEC Brings First Pay-to-Play Action Against an Investment Adviser

The SEC recently brought the first action under the "pay-to-play" rule adopted under the Advisers Act. The SEC also found that two affiliated exempt reporting advisers involved in the matter were operationally integrated and as such should have registered as an investment adviser.

Rule 206(4)-5 under the Advisers Act prohibits investment advisers (whether registered or unregistered) from providing advisory services in exchange for compensation to a government client for two years after the adviser or certain officers or employees of the adviser make a campaign contribution to certain elected officials or candidates for office related to that government client.

The SEC charged a venture capital firm whose associate contributed to candidates in the Philadelphia mayoral campaign and the Pennsylvania gubernatorial campaign in 2011. Both the mayor and governor appoint board members of public pension plans that had been investors in the firm's venture capital funds since 2000, and the firm provided advisory services to the pension funds.

It appears that the SEC is actively enforcing the "pay-to-play" rule under the Advisers Act. More interestingly, in this case the government clients in question first invested in the subject funds more than a decade before the associate made the campaign contributions, and at a time when the funds were winding down (but the adviser was still receiving fees). In other words, it seems that the SEC is applying Rule 206(4)-5 even if the government client invested with an adviser prior to the time of the political contribution. Investment advisers should ensure that they have robust internal procedures to monitor political contributions by employees and officers, including those made to preexisting government clients, and to act immediately when the pay-to-play rules may be triggered.

The SEC also found that the two affiliated advisers, who separately claimed to be exempt reporting advisers, were significantly operationally integrated and thus should have been integrated into a single investment adviser for purposes of determining whether they were required to register with the SEC. Once integrated, the adviser did not qualify for either of the exemptions it previously relied on and the firm was charged with failing to register itself and its affiliate as investment advisers.

Investment advisers in similar situations that seek to claim exemptions from registration with the SEC should consult with counsel familiar with registration requirements under the Advisers Act and carefully review their relationships with affiliates to determine if they should be integrated for purposes of the SEC's registration rules.

More details on this action can be found in our related client alert.

Investment Advisory Firm and Its Owners Charged with Failing to Disclose Conflicts of Interest

In yet another example of the SEC's enforcement program finding opportunity in examination priorities identified by OCIE earlier in the year (see our related client alert), the SEC recently brought fraud charges against an investment adviser for failing to advise clients that the adviser was receiving compensation from a broker offering mutual funds that the adviser recommended to its clients. The SEC found that the adviser received a percentage of every dollar that its clients invested in certain mutual funds, but that the compensation arrangement was not disclosed to clients.

The Asset Management Unit (AMU) of the SEC's Enforcement Division has undertaken an initiative to shed light on undisclosed revenue-sharing arrangements. AMU has also focused on conflicts of interest.

The case involved an arrangement between a broker and the investment adviser dating back to 2004. The SEC said that the arrangement created incentives for the adviser to favor certain mutual funds and to favor the broker's platform when giving advice to its retail and high-net-worth clients.

The SEC found that, from 2005 until 2011, the investment adviser failed to disclose the existence of the arrangement on its Form ADV or through any other means. Moreover, although existence of the arrangement was disclosed beginning in December 2011, the SEC found that disclosure to be inadequate because it did not clearly disclose the incentive to favor the mutual funds offered by the broker. The revised disclosure also stated that the adviser "may" receive compensation from the broker when, in fact, the adviser was actually receiving such compensation.

The investment adviser received a total of approximately $441,000 in payments from the broker.

The investment adviser in question has not settled the charges, which will proceed in front of an administrative law judge.

Lying to Examiners Can Lead Quickly to Criminal Charges

Hell hath no fury like a regulator (allegedly) lied to. In mid-August, the

SEC brought civil charges, and the U.S. Attorney for the Southern District of New York brought criminal charges, against a broker-dealer and its founder for falsifying books and records to hide capital deficiencies from SEC examiners, as well as for violating net capital requirements.

The SEC's enforcement action, brought as an administrative proceeding, alleges that the firm and its president attempted to disguise the firm's extensive and repeated net capital insufficiencies. The SEC alleges that the respondents improperly off-loaded liabilities onto the books of an affiliated firm and improperly treated non-marketable stock as an allowable asset. According to the SEC, the affiliated firm did not have sufficient resources to pay for the liabilities, which related to services actually performed for the firm. The SEC discounted an expense-sharing agreement between the firm and the affiliate as a sham.

More seriously, however, the SEC alleges that the firm's president tried to hide the broker-dealer's true financial condition by providing the SEC examiners with "falsified documents" that sought to mask the extent of the firm's liabilities. He was charged criminally for his alleged obstruction of the SEC examination and for making false statements and false filings. The charges carry maximum prison sentences of 20 years and five years, respectively.

Everybody knows that a regulated entity must maintain accurate books and records, and accurately report its financial condition. Everybody knows that a firm should not aggravate a situation by lying to examiners and falsifying documents. The lesson of these cases is that once it steps over the line and decides to attempt to deceive the regulators, the firm opens itself up to criminal prosecution. The Department of Justice is willing and able to support its civil partner and seek criminal sanctions for such conduct. Moreover, perhaps slightly less obvious but equally crucial, this case highlights the need for all firms and their personnel to be meticulous and vigilant about the accuracy of information provided to the SEC—lest an examination blossom into an enforcement action and explode into criminal charges.

Hedge Fund Manager Charged with Portfolio Pumping

The SEC recently charged a hedge fund manager and his related investment advisory firm with bilking investors out of more than $1 million under the guise of research expenses and fees. The SEC alleges that fees earned on two hedge funds managed by the adviser were declining due to the funds' worsening performance, and the owner of the investment advisory firm implemented a scheme causing the funds to reimburse him for fake research expenses. The SEC also alleges that the investors were charged twice for some of the fake research expenses because the funds were not only billed directly for such expenses, but soft dollar credits earned by the hedge funds were diverted to the adviser for the same "research."

According to the SEC, the adviser's owner used the direct fees to pay for country club dues, boarding school tuition, and luxury cars. The soft dollars were used to pay the salary of an employee identified as an accomplice in the scheme.

The two individuals were also charged with manipulating the price of a thinly traded stock that represented more than 75 percent of the value of the funds' portfolios. The portfolio pumping allegedly involved placing multiple buy orders immediately before the close on the last trading day of the month to drive up the closing price of the stock. In turn, this price increase "pumped up" the month-end valuation of the funds' portfolios.

The case is filed in U.S. District Court for the District of Minnesota.

Something Old, Something New: SEC Brings Action for Prohibited Principal Transactions and Retaliation Against Whistleblower

Clearly signaling its intention to support whistleblowers who provide actionable evidence of wrongdoing, the SEC recently settled the first case brought under the authority granted by the Dodd-Frank Act enabling anti-retaliation enforcement actions. The case arose after an employee of a hedge fund advisory firm reported potentially illegal activity related to improper principal transactions.

According to the SEC's order, the head trader of a registered investment adviser (RIA) made a whistleblower report to the SEC alleging that the RIA was engaged in prohibited principal transactions with an affiliated broker-dealer. The broker-dealer was majority-owned by the RIA's chief investment officer (CIO), who was also the controlling shareholder of both the RIA and the broker-dealer.

After investigating the whistleblower tip, the SEC found that the CIO sometimes instructed the traders to sell securities with unrealized losses to a proprietary trading account at the affiliated broker-dealer. Realized losses from the trades were allegedly used to offset the fund's realized gains in an attempt to reduce the tax liability of investors in the fund. Use of the proprietary trading account facilitated the CIO's ability to later repurchase attractive securities for the fund, the SEC alleged.

Section 206(3) of the Advisers Act generally makes it unlawful for an RIA, directly or indirectly, "acting as principal for his own account, knowingly to sell any security or to purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client." In this case, however, the CIO also controlled the fund's general partner. As a result, written disclosure of the principal transactions to the fund was ineffective, as was the fund's consent to those transactions.

The SEC also found that the RIA's conflicts committee was insufficiently independent because one member of the two-person committee was the chief financial officer of both the RIA and the affiliated broker-dealer.

The head trader made his report to the SEC in March 2012 and informed the CIO of the report in mid-June. One day later, the RIA removed him from his day-to-day activities on the trading desk. He was instructed to work off-site to prepare a report detailing the facts supporting the potential violations that he had reported to the SEC, and his access to certain trading and account systems, as well as his company email account, was restricted.

At no time was the trader's compensation reduced or his benefits affected. He was, however, never reinstated in the head trader role. After approximately one month, he resigned his position.

The SEC found that the RIA violated Section 21F(h) of the Exchange Act, which prohibits an employer from discharging, demoting, suspending, threatening, harassing, directly or indirectly, or in any other manner discriminating against, a whistleblower because of any lawful act done by the whistleblower in providing information to the SEC. The RIA was also found to have violated Section 206(3) of the Advisers Act, as described above, and Section 207 of the Advisers Act, because the RIA's Form ADV contained materially misleading disclosure regarding its conflicts committee.

The SEC ordered the RIA to pay $1.7 million to certain fund investors and retain the services of an independent compliance consultant to conduct a comprehensive review of the RIA's compliance policies and procedures.

The action was settled without the RIA admitting or denying the allegations.

VA Switches: FINRA Disciplinary Action Reminds Firms About the Need for Adequate Supervisory Procedures

In a case involving unsuitable variable annuity (VA) transactions, FINRA found that having good procedures and discovering improper conduct are not enough. A member firm must also ensure that it has adequate supervisory systems in place to ensure that its procedures are properly implemented. In this case, two of the firm's registered representatives—who were independent contractors—recommended and effected unsuitable VA transactions for their customers, causing their customers to pay unnecessary surrender fees on VAs that had only been held for two to three years, and incurring longer surrender periods on new VAs.

FINRA's facts and figures give a good sense of the seriousness of the conduct. One of the brokers switched 140 customers who held 214 fixed or variable annuities to a VA issued by an unaffiliated third-party insurance company, costing the customers approximately $208,000 in unnecessary surrender penalties and earning the broker $380,235 in commissions. The other broker switched 66 customers who held 87 fixed or variable annuities to the same unaffiliated VA, costing the customers approximately $155,173 in unnecessary surrender penalties and earning the broker $196,684 in commissions. As a result of each replacement transaction, the customer incurred a new surrender period.

It gets worse. FINRA found that the brokers employed a "one size fits all" investment strategy, notwithstanding the diversity of their customer base. Although the customers were between the ages of 27 and 73, some were working and some were retired, and they had varied net worths and income, the brokers classified all of their customers as having the same risk tolerance and primary investment objectives. In addition, the brokers switched substantially all of their customers into the same VA, the same rider, and the same asset allocation investment fund option.

FINRA fined the firm $100,000 and found that while the firm's written procedures generally addressed suitability considerations related to VA sales, its systems had the following deficiencies:

- The firm failed to ensure that sales of VAs by these representatives adhered to its written procedures;
- The supervisors approved VA replacements based on limited firm systems and with inadequate written guidance, computer systems, and surveillance tools;
- The firm failed to verify the amount of surrender fees reported by its brokers on replacement transactions, which were underreported; and
- The firm also did not have a system or Web-based access to a database that allowed it to adequately compare the annuity to be replaced with the other VAs.

FINRA also found that, as a result of the firm's limited systems, it was unable to identify the substantial volume of VA replacement activity for the brokers. The firm also did not identify trading trends in customer accounts, including when customers surrendered one VA and switched into the same VA; when customers purchased replacement VAs with substantially the same investment objectives and risk tolerance, asset allocation investment fund options, and riders; when VA replacement paperwork had substantially the same rationale for the replacement of the prior VA; and the existence of other red flags. FINRA noted that the two brokers were supervised remotely by firm managers.

The firm consented to the sanctions without admitting or denying the findings.

This was a relatively extreme case of sales practice abuses involving sales of VAs, but it presents a good opportunity to remind member firms that FINRA continues to scrutinize procedures and practices with respect to the sales of VAs.

TIDBITS

- On August 28, 2014, the SEC announced a $300,000 whistleblower award to an audit and compliance professional who reported on a company's wrongdoing.
- On August 27, 2014, the SEC adopted final rules requiring credit rating

agencies to enhance governance, protect against conflicts of interest, and increase transparency. The new rules are designed to improve the quality of credit ratings and increase the accountability of credit rating agencies.

- On August 27, 2014, the SEC adopted revisions to rules governing the disclosure, reporting, and offering process for asset-backed securities. The SEC said that the revised rules are designed to enhance transparency, better protect investors, and facilitate capital formation.
- On September 9, 2014, the CFTC granted exemptive relief from certain provisions of CFTC Regulations 4.7(b) and 4.13(a)(3) to be consistent with amendments to Regulation D and Rule 144A implemented in response to the JOBS Act. The relief applies to entities that may be commodity pool operators (CPOs) but that plan to rely on Rule 506(c) (the "general solicitation" rule) or employ resellers relying on Rule 144A. The CFTC granted the exemptive relief because, currently, its regulations prohibit marketing to the public. The relief is not self-executing; CPOs seeking to rely on the relief must file a notice of their intention to do so with the CFTC.
- On September 5, 2014, the SEC announced the appointment of Brent J. Fields as Secretary of the Commission. As Secretary, Mr. Fields will be responsible for overseeing the administrative aspects of the SEC's meetings, rulemakings, and procedures. Mr. Fields is an 18-year veteran of the SEC's staff who has worked primarily in the Division of Investment Management.
- On September 5, 2014, the SEC announced that Tracey L. McNeil was appointed as the agency's first ombudsman. Creation of the role was required by the Dodd-Frank Act. The ombudsman will act as a liaison in resolving retail investors' problems with the SEC.
- On August 26, 2014, the SEC named James Schnurr as Chief Accountant. Previously, Mr. Schnurr was vice chairman and senior professional practice director for Deloitte LLP.
- On August 20, 2014, the SEC announced that Chief Information Officer Thomas Bayer would be leaving the agency. Mr. Bayer has led the SEC's Office of Information Technology since October 2010.
- On August 8, 2014, the SEC announced that Thomas M. Piccone would lead the National Exam Program in the agency's Denver regional office. Mr. Piccone joined the SEC's Denver office in 1997. Prior to joining the staff, Mr. Piccone was in private practice and served as a law clerk for U.S. District Court Judge Alfred A. Arraj.
- On July 21, 2014, the SEC announced that Mark J. Flannery was appointed as Chief Economist and Director of the SEC's Division of Economic and Risk Analysis. Dr. Flannery is a finance professor at the University of Florida's Warrington School of Business Administration.
- On June 27, 2014, the SEC announced that Adam D. Storch, the Chief Operating Officer and managing executive of the agency's Enforcement Division, was leaving the agency.
- On June 27, 2014, the SEC announced that Geoffrey Aronow, the Chief Counsel and Senior Policy Adviser to the agency's Office of International Affairs, would be leaving the agency.

NEW LENDING TRENDS, SME LENDING, AND OTHER DEVELOPMENTS

Join us for an upcoming briefing session on September 18, 2014. During this session, we will discuss new lending trends that have developed for middle market and small companies following the financial crisis. For example, nonbank lenders, including business development companies, and certain bank lenders are providing these companies with more tailored financing options. These financing alternatives may include mezzanine financing, PIK features, equity kickers, second lien loans, or unitranche loans. The speakers will discuss the topic from a business and legal perspective. The session will include discussion of the following:

- Regulatory and Other Pressures on Banks;
- Growth of Nonbank Lenders;
- New Financing Structures;
- More Tailored Terms;
- Advantages and Disadvantages; and
- Cross-border Trends.

Our speakers include Michael Girondo, Head of Capital Markets, Varagon Capital Partners, and MoFo partner, Geoffrey Peck.

RSVP here: http://www.mofo.com/resources/events/2014/09/140918newlendingtrends

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