BDWEEK

Regulatory news and compliance best practices.

INSIDE...

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Violations would be more widely publicized under FINRA proposal

More of the sanctions and complaints that are included in *BrokerCheck* reports could make their way into the monthly summary of disciplinary cases that **FINRA** posts for the public to see on its web site, under a proposal the SRO's Board of Governors approved this month.

Currently, the severity of a sanction or a complaint must reach a certain threshold before it's published in the monthly report, and the proposal would do away with that threshold. In general, the threshold includes, for resolved cases, fines of at least $10,000, suspensions, bars or expulsions. In addition, complaints that allege violations of certain

(FINRA Board, continued on page 2)

Enforcement Alert

Settlement illustrates the need to be cautious with advertising language

A recent **FINRA** settlement shows examples of advertising language the regulator says went too far in promising the upside of the products. Protect yourself by making sure your firm's advertising clearly discloses product risks, says one compliance pro, while another says you might want to seriously consider having FINRA's advertising department review material you're unsure of.

In a July 11 settlement, FINRA fined Houston-based **Sanders Morris Harris, Inc.** $75,000 after finding that in 2008 it distributed nine hedge fund advertising items to retail customers that violated advertising rules. Among the problems, the material:

✔ didn't disclose risks related to investing in hedge funds;

✔ contained unclear charts and graphs;

(Advertising , continued on page 5)

No-action letter addresses merger and acquisition work by foreign firms

A recent **SEC** no-action letter broadened the type of party that could be considered a major, U.S. institutional investor, thereby allowing foreign firms to play roles in merger and acquisition transactions with such investors without having to register as broker-dealers with the Commission. Instead, the foreign firms could rely on the Exchange Act rule 15a-6 exemption, which allows foreign firms to be chaperoned by a U.S. broker-dealer as an alternative to registering.

The investors don't meet the financial standard in the regular requirement, which calls for the investor to have at least $100 million in "financial" assets, or, in the case of an investment adviser, that much under management. Instead, the SEC allowed assets such as real estate, equipment, and intellectual property to count toward the $100 million threshold, under the noaction letter.

(No-action letter , continued on page 4)

FINRA Board *(cont. from pg. 1)*

designated rules would surpass the threshold.

The changes would amend FINRA rule 8313 (which deals with disciplinary information released to the public), "thereby promoting increased transparency of FINRA's disciplinary process," according to a July 13 FINRA communication to firms.

Based on the description in the communication, some industry players interpreted the proposal as a plan to possibly allow the public to see disciplinary information from Form U4s that's not in *BrokerCheck.* They said that would be unfair because of the large amount of non-adjudicated allegations on Form U4s.

But FINRA told *BD Week* that the "public" information would come from information that's already included in *BrokerCheck* reports.

Atlanta consultant **Michael Brown**, who read the proposal as allowing all disciplinary information on Form U4s to be made public, said the communication to firms about the matter was vague. "The transparency of this summary is muddy at best," said Brown, adding that FINRA doesn't provide lots of details in its summaries of decisions made by the board, which conducts closed meetings.

"The proposal eliminates existing publicity thresholds for the release of disciplinary information and provides for the release of all disciplinary complaints and disciplinary decisions to the public. The changes would allow FINRA to release to the public certain disciplinary information that is already publicly available in *BrokerCheck*," said the July 13 communication. The changes would apply prospectively, FINRA said.

Heidi Tickle, senior consultant in the New York office of **Frontline Compliance, LLC,** interpreted FINRA's notice as possibly indicating that more information from *BrokerCheck* might be published in the monthly disciplinary reports.

"I think it gives them [FINRA] a little bit more leverage to communicate more broadly to the public the transparency of what is otherwise available to them," , she said.

Markups rule expansion

Another proposal from the board would extend FINRA's rule prohibiting excessive commissions and markups to cover government securities (except U.S. Treasury securities).

The markups rule, also known as "the 5% rule," includes guidance from 1943 that says a commission or markup exceeding 5% is considered excessive. The 5% guidance is somewhat archaic and many markups and commissions are less than that.

"Commissions on equity securities have been generally lower than 5% for many years now, and fixed income securities, government securities, have mark-ups and/or markdowns that vary more than equity securities historically," Tickle said.

The spirit of the excessive commissions rule would support inclusion of government securities, Tickle said.

(FINRA Board, continued on page 3)

FINRA Board *(cont. from pg. 2)*

She noted that FINRA Regulatory Notice 11-08 states: "the member shall buy or sell at a price which is fair and reasonable, taking into consideration all relevant facts and circumstances, including… the fact that the member is entitled to remuneration."

As for how compliance pros would be affected, Tickle said they would have to consider how the rule changes affect their surveillance reports, supervisory reports, and review and control mechanisms. Depending on the sophistication of their surveillance reports, firms might need to make technological changes in line with the new rule and implement those changes in relatively short time periods, she said.

Last year, FINRA proposed removing guidance in the rule that refers to the 5%, then after industry complaints about the idea of removing it, said it would seek comments on the idea of keeping such language.

Michael Clements, president of **Wall Street Consulting Services LLC**, based outside of Boca Raton, Fla., applauded the idea of FINRA proposing to extend the commissions rule to government securities. He said it's "a great stride" in creating a uniform policy to cover stocks and government securities.

But he said regulators need to add "teeth" to the proposal by requiring firms to disclose the amount of the markups on trade confirmations customers receive for bond transactions, thereby paralleling the requirements covering stock transactions.

Clements said customers and regulators are missing the problem of firms charging excessive markups and markdowns for transactions involving government securities. Some firms that had been charging excessive commissions for stocks started receiving complaints from clients and then started doing more bond business and overcharging customers for that, but the problem has been difficult to detect, Clements said.

Rule 4530 reporting

Another board proposal will make things easier for firms, some compliance pros said. The proposal would eliminate the requirement that firms make Rule 4530 self-reports of certain rule violations where the violation has been reported on a Form U4. Firms would be able to make a request on the CRD that data reported on certain U4 disclosure pages be applied to the Rule 4530 reporting requirement.

"I saw this as technological innovation on FINRA's part," Tickle said. "One submission will satisfy what would have otherwise been two separate online entry requirements."■

Peers offer advice for selecting a new e-mail vendor

One of the first signs of trouble was the vendor slowed down in returning phone calls. The poor service opened a crack that swelled into a crevice. The adviser concluded it was time to find a new e-mail archivist.

The ultimate disappointment occurred when the vendor tried to "hold me hostage to my own information," recalls CCO **John Megyesi** at **Alpine Woods Capital Investors** ($5.1B in AUM) in Purchase, N.Y., referring to ownership of the firm's old e-mails.

A CCO in Connecticut ran into a similar experience when her firm grew "pretty dissatisfied" with its e-mail vendor. After selecting a new company, the CCO discovered the jilted firm insisted on charging "incredible sums of money to get your data out." Her advice: Go in knowing what you're getting and the cost of taking archived e-mails when you leave. "You have to ask about it," says the CCO, because the firms won't volunteer the answer.

"They're going to make you pay for it when you leave because they don't want you to leave," says **Adam Reback**, CCO with **J. Goldman & Co.** ($895M in AUM) in New York. He had the unique experience of dumping a vendor only to go back to it after becoming disenchanted with its replacement.

In luring back the old vendor (**Smarsh**), Reback was successful in negotiating the excision of any exit costs. Do so before you sign on the line because "once you're with the vendor, there's not a lot you can do" about it, he says.

Nick Taylor, corporate controller at **Morgan Creek Capital Management** ($9.1B in AUM) in Chapel Hill, N.C., spent months negotiating with two e-mail vendors. He succeeded in negotiating a cap on

(E-mail, continued on page 4)

E-mail *(cont. from pg. 3)*

the price for past e-mails should his firm later flee to another vendor. The process, which was "more time consuming than expected," paid off. It highlighted which vendor truly wanted the firm's business. The more flexible vendor won, while the strident firm was deleted like spam.

If negotiating isn't your strong suit - Taylor enjoys it - then bring in someone who thrives in the white-knuckle exercise, he recommends.

Tips to find the right vendor

There's no question that firm business e-mails must be preserved for three years. Most firms hire a vendor to save the records.

Many of your peers call references, rely on recommendations from peers or consultants, request quotes from multiple vendors, ask for financial documents and disaster plans and ultimately decide with input from their technology specialists.

Vincent Campagna, CCO with **Wafra Investment Advisory Group** ($4.7B in AUM) in New York, found a distinctive way to test a vendor's mettle. He provided the company with a batch of past e-mails to challenge its system. "This gave us a chance to conduct real-life searching," he says. "That was very helpful." Before doing so, have the firm sign a confidentiality agreement, he recommends.

Ask questions, such as what happens if your remote site goes down, adds **Lisa Ploschke** CCO **at Hillview Capital Advisors** ($1.3B in AUM) in Radnor, Pa. Inquire as to protections to prevent your data from becoming scrambled with e-mails from other clients. Make sure the vendor's system can integrate with your e-mail program, e.g., **Microsoft Outlook**.

Ploschke also asked for the firm's SAS 70 report (some vendors may offer alternate financial documents, such as balance sheets), its privacy policy, disaster recovery plan and about firewalls and redundant locations. In the end, the IT staff elected to go with Microsoft.

While it was a cheaper answer, "you don't get personalized service" and "when it comes to training, you're kind of on your own," she says.■

No-action letter *(cont. from pg. 1)*

Under the regular requirement, financial assets are limited to "cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures and other derivative instruments," according to the July 12 no-action letter, which was requested by **Ernst & Young Corporate Finance** (Canada) (EYCF[C]).

EYCF(C) is a broker-dealer registered with the SEC and a member of **FINRA**. The foreign firms and EYCF(C) are members of **Ernst & Young Global Limited**, the letter said.

Recounting how EYCF(C) characterized what the investors' assets would be, the Commission said, "You state that such party is sophisticated with respect to its business and holds more than $100 million in total assets (excluding cash and cash equivalents) that include, but are not limited to: plant; equipment; real estate; intellectual property; and the unimpaired goodwill arising from prior acquisitions, among other assets."

The relief was requested only for private placements of stock or other forms of equity securities, and only in the context of mergers or acquisitions that would result in the transfer of control of an entire company or business unit.

D. Grant Vingoe, a partner at **Arnold & Porter** who crafted the no-action request, said the Commission is just coming around to recognize assets such as plants. He said the rule 15a-6 exemption originally was envisioned as a way to accommodate traditional brokerage activities and institutional investors were narrowly defined to be financial entities. The Commission didn't contemplate that there might be "regular corporations" that wanted to exchange shares, for example, in an acquisition, he said.

"The term institutional investor doesn't neatly describe entities engaged in M&A transactions with each other," Vingoe said. "So this letter acknowledges that companies can be chaperoned even if they're not traditional financial institutions … and if they have assets that they're using in their business like plants and equipment."

Another reason the Commission is just now recognizing such assets in the institutional investor

(No-action letter, continued on page 5)

No-action letter *(cont. from pg. 4)*

definition is that relief sought in the past was requested by large securities firms that mainly wanted foreign affiliates to be able to be chaperoned in connection with brokerage services provided to U.S. institutional investors. Those firms were focusing on traditional brokerage activities as opposed to mergers and acquisitions, he said.

Vingoe said the no-action the letter could be seen by some foreign firms as a reminder that their actions with M&A could give rise to SEC broker-dealer registration requirements and they need to rely on the exemption to safely conduct business in the U.S.

He lauded the SEC staff for processing the letter when they are busy dealing with financial reform issues.

"It shows a willingness of the SEC staff, even in the face of all the Dodd-Frank rulemaking, to address interpretive questions where there's a gap in the way that a regulation operates. I think the staff really extended itself in the face of all the obligations they have at the moment to address this type of issue of importance to a segment of the financial sector."■

Advertising *(cont. from pg. 1)*

✔ weren't reviewed by a principal before distribution; or

✔ made misleading or exaggerated claims.

"The decision as to what a firm can and can't say in an advertising piece has now become almost an art form, especially if the product involved is of a risky nature or is considered to be 'complex'," said **Diane Golbeck**, a Port Orchard, WA attorney and former FINRA examiner.

"More than once in recent history, I've recommended to my clients that if there are any doubts as to a piece they've created, they should spend the money and submit it to the FINRA advertising department for review. And when it comes to a piece created by another firm or product sponsor, don't assume it's OK to disseminate as is. Ask them what reviews were conducted and if doubts then remain, either don't send it out, or submit it yourself and pay the fee," Golbeck said.

The settlement said the following advertising statements inappropriately implied that past performance was an indicator of future positive returns:

✔ "Though the Fund was launched in April 2004, the investment theory has been in practice by sophisticated investors for years and has been validated across a variety of market cycles";

✔ "Avoiding periods of negative return and minimizing volatility have historically proven to increase investment performance through the power of positive compounding"; and

✔ Over the last 10+ years, major university endowments (those with investment portfolios in excess of $1 billion) have utilized cutting edge investment strategies that have managed to outperform most investors on a risk-adjusted basis."

In addition, the following advertising statements, FINRA said, were misleading because they implied a promise of positive future returns or implied that negative returns could be avoided:

✔ "Adherence to Disciplined Asset Allocation Parameters Removes Emotion from Investing … Improving Likelihood of Buying Undervalued Assets";

✔ "Avoiding periods of negative return and minimizing volatility have historically proven to increase long-term investment performance through the power of positive compounding. The manager believes that this is a way to invest 'stay rich' capital" and;

✔ "What is the appeal of a large institutional endowment style of investing to the individual investor?"… "Wealth Preservation – A 'Stay Rich' approach is the objective."

The settlement also said one of the advertising pieces stated that a fund had "[a]n investment program comparable to what is available in Large University Endowments." FINRA said that was misleading because it exaggerated the similarities between the fund and large university endowments.

Mary Hodges, an attorney with **Cosgrove Law, LLC** in St. Louis, said, "It's not enough to only include risk disclosures within a company's transaction agreements once the client actually decides to open the account because it's the advertising materials that actually may induce business with that company in the first place. So, not including these risk

(Advertising, continued on page 6)

Advertising *(cont. from pg. 5)*

disclosures in the advertising materials potentially opens the broker-dealer up to liability, especially if customers and clients are relying on statements that may indicate there is no risk in investing in certain products, or past performance is indicative of future returns."

Phrases such as "have historically proven to increase" might cause you problems if not accompanied by disclosures about risk, Hodges said.

"It's really important for broker-dealers to be certain that all of their advertising materials contain adequate risk disclosures and remain in the parameters of FINRA rule 2210," Hodges said. "That being said, based on the type of industry that it is, oftentimes there's a struggle for broker-dealers to find the right way to market and sell their products while essentially not being able to guarantee that product's performance because the rule does not allow it. So, sometimes that fine line is blurred and it's hard to discern whether the materials are appropriate or not."

Keep in mind that FINRA occasionally issues regulatory notices that contain examples of problematic language used to advertise certain kinds of products, Hodges said. Those notices might be helpful as firms create their advertising materials, she added.

Golbeck said she doesn't necessarily agree with some of FINRA's findings in the Sanders settlement but "there is a good lesson here regarding the caution that must be taken with respect to communications with the public, and firms would be wise to re-review pieces that they currently have approved."■

Early bumpy days of electronic SAR-filing should be over, FinCEN says

Some firms faced a few bumps in the road dealing with the new system to file Suspicious Activity Reports electronically, which became mandatory July 1, says the **Financial Crimes Enforcement Network**. But FinCEN said the system is functioning properly now. Firms whose filings were rejected should have received an electronic notification and should re-file the reports, FinCEN said. It also says regulators should consider these problems when they review your filings for this period.■

MSRB guidance on new conflicts rule addresses responses to RFPs

The **MSRB's** new rule that requires underwriters to disclose conflicts to issuers also prohibits underwriters from making misrepresentations when responding to a request for proposal, the board says in recent guidance on complying with the new rule, which takes effect Aug. 2. Just because it's an RFP doesn't mean there won't be regulatory consequences if you mislead the issuer, the guidance says.■

Group Publisher Hugh Kennedy

Executive Editor Vincent Taylor

Contributing Editor Carl Ayers

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