

## MEMORANDUM

TO: Clients and Friends of the Firm

FROM: Securities Regulatory Practice

DATE: November 20, 2006

SUBJECT: Securities Industry Association – Compliance and Legal Division  
Fall Compliance Seminar in New York City, November 13, 2006

The Securities Industry Association – Compliance and Legal Division (now known as the Securities Industry and Financial Markets Association (“SIFMA”), following the merger of SIA and the Bond Market Association), held its annual Fall Compliance Seminar in New York City on November 13, 2006. Several members of the Morgan Lewis Securities Regulatory Practice attended the seminar and have highlighted in this outline some remarks from the general and breakout sessions by senior NYSE Regulation, NASD, SEC and NASAA staff. We hope you find this information useful in your practice.

### **Overview**

Richard Walker of Deutsche Bank moderated the general session and began by asking the senior enforcement officials on the panel (Linda Thomsen, Director of Enforcement, SEC, Susan Merrill, EVP, Enforcement, NYSE Regulation, James Shorris, EVP, Enforcement, NASD, and Joseph Borg, Director of the Alabama Securities Commission and President of NASAA), what the current “state of play” was in the light of the past four to five years of intense enforcement activity. Ms. Thomsen, speaking for herself and not on behalf of the Commission, remarked that new enforcement issues would always arise to capture regulators’ attention. She noted that recent enforcement actions have made the industry better and more compliant, and said that the industry has begun to prevent, through diligent effort, smaller problems from becoming bigger ones. Ms. Merrill told attendees that, overall, the industry is better off for having come through the enforcement processes of the last few years, especially in the area of conflicts of interest review. She noted that, in general, compliance policies and member firms’ mindsets have improved, as evidenced by the fact that informed decisions are being made at the highest levels, which she said has led to a more open approach between regulated firms and NYSE Regulation. Mr. Shorris noted that while current enforcement activity appeared to be at an ebb, new areas of concern to enforcement officials always arise. For example, demographic changes are causing regulators to pay more attention to issues related to retirement plans and sales practices aimed at older populations.

## **Sweeps**

Ms. Merrill indicated that NYSE Regulation would continue to use sweeps as an enforcement tool, though it would do so more selectively. She said that the staff was more willing to engage in meetings with member firms in order to discuss issues rather than send out sweep letters. She suggested that during these informal discussions firms were more willing to participate and provide information than they may otherwise be upon being asked to provide written responses to a sweep letter. Ms. Merrill indicated that these informal meetings help NYSE Regulation to target information gathering in sensitive areas (she referenced back-book trading as one issue) and to target sweeps more effectively.

Mr. Shorris agreed with Ms. Merrill and said that the NASD was trying to use sweeps more judiciously. He also said that the NASD was focused on dealing more efficiently with the tremendous amount of information available to the staff. He said that the staff is working on doing a better job of mining information from a variety of sources, including their own electronic surveillance reports through to and including the monitoring of internet blogs.

When asked to comment on statements from SEC Chairman Cox, who had indicated that OCIE would be notifying the Commission of any sweep efforts, Ms. Thomsen said that sweeps were here to stay. She indicated that sweeps would become more refined and focused, but that they were very useful in helping regulators understand problems and issues from a broad-based perspective. She noted that the SEC took pains to understand industry trends and issues as a whole but that she recognized that the information did not always need to come from firms. She said that the SEC also looked to additional sources of information including academic research to “get ahead” of issues before they “blow up.” Ms. Thomsen was specifically asked whether there was a process in place in the Enforcement Division of the SEC to “clear” sweeps before they went out to the street, and she replied that sweeps would not happen without her knowing about them.

## **Hedge Funds**

Regarding hedge funds, Ms. Thomsen told the audience that the SEC would continue to “follow the money.” She said the potential for abuse was high simply because there was so much money involved. She said that the SEC would continue to focus on customer abuse as well as market abuse, and that the Commission has brought cases in both areas. Regulators will continue to examine hedge funds’ involvement in cases involving misappropriation and disclosure issues along with trading and market manipulation. She also commented that lack of hedge fund transparency continues to be an issue for the SEC.

From the perspective of state regulators, Mr. Borg said that they were closely watching the impact of the “retailization” of hedge funds. Mr. Borg noted that individual investors who may not otherwise be involved with a hedge fund are getting involved in them through either pension or retirement plans. He said the problem was one of transparency and whether individuals misperceive the role of hedge fund manager as being akin to an

investment adviser. Ms. Thomsen seconded these concerns and remarked that it was difficult to truly define what constituted a hedge fund these days.

Regarding NYSE Regulation, Ms. Merrill noted that its window into hedge funds was through broker-dealers. She said NYSE Regulation was concerned about brokers or traders getting inside information or giving preferential treatment to hedge fund clients and then turning a blind eye to possible misconduct because there is so much money involved in the relationship. Of particular concern were hedge funds violating Reg M by shorting stock and covering with stock obtained in a secondary offering; this is especially troubling in the those cases where the hedge fund's prime broker is part of the underwriting syndicate. She said NYSE Regulation expected member firms acting as prime brokers to hedge funds to "put information together" that would reveal such violations. Ms. Merrill also said that NYSE Regulation was paying close attention to broker-dealer affiliated hedge funds. Among the issues raised by such relationships are the roles and responsibilities of dual-hatted employees and the treatment of order flow.

Mr. Shorris noted that, when it came to hedge funds, NASD's jurisdiction was limited. He said that they were focused on issues such as suitability, soft-dollar payments, and the supervision of registered persons inside hedge funds. He also indicated that certain activities by hedge funds may raise anti-money laundering concerns, including whether certain large transactions require the filing of suspicious activity reports.

Ms. Thomsen noted that Chairman Cox has recently testified that the SEC was considering raising the minimum levels for qualification as an accredited investor. She said that if the justification for the light regulation of hedge funds was because investors are sophisticated, then perhaps the thresholds for determinations of sophistication should go up. Mr. Borg seconded this notion and suggested that the current level of \$1 million was not high enough and that perhaps the threshold amount needed to be raised to \$2 million, excluding residential real estate.

### **Insider Trading**

When asked to respond to speculation in the press that insider trading was increasing, Ms. Thomsen said that insider trading "never went away." She said among the current challenges facing regulators is determining whether certain information is public or non-public. She noted that hedge funds were a ripe place for insider trading and that the SEC has brought several cases involving insider trading in PIPE deals. She said that while these were difficult cases to prosecute, the Division of Enforcement got a "big bang for the buck" in bringing these cases because of their deterrent effect.

Ms. Merrill noted that NYSE Regulation saw an uptick in referrals to the SEC for insider trading violations. She said that from 2004 to 2005 there was a 63% increase in referrals to the SEC. Year-to-date in 2006, NYSE Regulation was on pace for another 26% increase above 2005. A number of the insider trading referrals related to hedge fund activity. Ms. Merrill believes that when NYSE Regulation brings these cases it dampens any interest or temptation to take advantage of the selective disclosure of information. In light of these actions, for example, analysts are less likely to disclose information to their

proprietary trading desks or clients before that information makes its way into the marketplace. Noting the difficulty of differentiating between someone who obtains information through legitimate research means versus those who obtain information through illegitimate means, Ms. Thomsen remarked that when information looks like it is derived through “dumpster diving,” an individual may have “crossed the line.”

### **Large Block Trading**

The panel was asked to discuss issues related to large block trades, such as when a firm goes to a hedge fund on a no-names basis to find expressions of interest in a particular block of securities. Discussions between member firms and NYSE Regulation indicate that these practices vary widely from firm to firm. Ms. Merrill said that one facet of these deals that will be examined by regulators is whether there was disclosure to the firm’s customer that the block is being shopped, and whether there was disclosure to the potential customer that, in connection with the query, they would be getting confidential information that may result in their being restricted from trading. She noted that some firms go so far as to ask hedge funds to acknowledge, in connection with one of these inquiries, that they are receiving confidential information and that they will not trade on the information. Ms. Merrill has also noticed hedge funds pre-hedging following these solicitations of interest, which regulators fear can condition the market. She said that the regulators would be looking for clearer disclosures in connection with this type of activity.

### **Conflicts of Interest**

The panel was asked whether the industry would be seeing any written guidelines on conflicts of interest best practices. Ms. Thomsen indicated that a formal statement of best practices from the SEC was not imminent. Ms. Merrill said there has been some frustration in terms of developing written best practices, but she said that NYSE Regulation has formed a conflicts of interest task force and that that task force would be looking at certain issues, including back-book trading.

The panel also discussed a recent decision from the Australian Securities and Investments Commission regulator with respect to Citigroup Global Market Australia. This case, ASIC No. 06-096, which can be viewed at <http://www.asic.gov.au/asic/>, involved allegations that Citigroup improperly entered into proprietary trades in the stock of a company for whom it was also doing investment banking work. ASIC alleged, among other things, that Citigroup “did not have in place adequate arrangements for the management of conflicts between its own interests and the interests of its client.” In its action, ASIC relied on its “Policy Statement 181 Licensing: Managing Conflicts of Interest,” which states that some conflicts of interest have such a serious potential impact that the only way to manage those conflicts adequately will be to avoid them. In such cases, mere disclosure or use of internal controls will be inadequate. Ms. Merrill recognized that there was a fear among member firms that this case meant that the traditional information barriers between banking and trading either were not working or would be not recognized as appropriate. In discussing the facts of the case, she noted that Citigroup had in place information barriers that permitted the trading desk to continue to

trade in a stock of a target company prior to the announcement that Citigroup was representing the acquiring company. She mentioned that the information wall in place was meant to allow the traders to continue to trade while the investment banking side was working on the deal. She noted that the particular facts of that case involved many alleged breaches of those information barriers and, if that was indeed so, it represents a more typical case. What was atypical about the Citigroup ASIC case were allegations that Citigroup was not properly managing the trading because trading could affect the price of the deal in place. The question then became whether the trading side could rely upon the integrity of the information barrier. While the case presented an interesting question, Ms. Merrill did not expect NYSE Regulation to substantially re-think its position on current information wall practices.

### **Proprietary Trading**

Mr. Shorris said that NASD reviews regarding proprietary trading were still in progress. NASD's main concerns were about the improper leakage of information. He indicated that NASD may take a rule-making approach rather than enforcement approach to addressing issues that arise following these reviews. Ms. Merrill said that NYSE Regulation was conducting examinations regarding proprietary trading through Member Firm Regulation and that there had been no enforcement referrals at this time. She also indicated that there may be non-enforcement ways to approach any problems that are discovered.

### **Gifts and Gratuities**

Mr. Shorris said that NASD had looked at 48 firms and found a "disappointing" lack of control over gifts and entertainment. Principally, he said they found a problem with the fact that there were sparse records to review for supervisory purposes. He noted that the staff saw numerous violations of Rule 3060, but not many that were egregious. Mr. Shorris said the street could expect to see enforcement cases in egregious circumstances.

Mr. Shorris reported that the NASD is taking principles-based approach in connection with its proposed gift and gratuity rule. Firms would be left to decide what was appropriate, and while they generally would not be second-guessed, firms needed to keep track of and supervise the issue. Mr. Shorris also noted that with respect to gifts, the staff saw confusion among firms. Moreover, the staff noted firms making exceptions to their own gift policies that seemed to lack appropriate supervision.

### **Sales Practices/Fee-based Accounts**

NASD continues to examine fee-based accounts. Mr. Shorris said that firms should continue to be on the lookout for red flags such as inordinately high profitability rates for certain products. He emphasized that prior NASD Notices to Members advised firms to assess the suitability of fee-based accounts and update their reviews periodically. Mr. Borg said that state regulators were also looking at fee-based accounts to the extent that there may be trends towards the use of those types of accounts for long-term

investing. This trend, to the extent there is one, raises disclosure issues and issues of whether firms are taking on investment advisory roles rather than simply charging a fee for brokerage services.

### **Enforcement top priorities**

#### **NASD**

Mr. Shorris listed the following current enforcement priorities for NASD:

1. Variable annuities -- including issues surrounding the exchange of variable annuities for equity indexed annuities;
2. Bank affiliated broker-dealers and variable annuities marketed through those affiliates;
3. Research analyst rules -- including disclosures, employment relationships, and trading against recommendations;
4. Anti-money laundering;
5. MSRB issues;
6. Microcaps;
7. Marketing of closed-end funds;
8. Accuracy of U-5 reporting; and
9. SPACs (special-purpose acquisition companies).

#### **NYSE Regulation**

Ms. Merrill listed the following current NYSE Regulation enforcement priorities:

1. Quality of markets issues (firm quote, limit order display, execution of ITS trades, hybrid market issues);
2. Market timing (NYSE Regulation's focus is shifting to individual RRs and supervisors); and
3. Sales practice issues (NYSE Regulation will continue to review complaints for trends. It is also examining sales practice issues with respect to registered representatives and family members as well as undisclosed employee outside businesses. For retirement issues, NYSE Regulation intends to put out an Information Memo regarding how firms

should deal with rollover IRAs. (In fact, this Information Memo was released on November 16, 2006 (06-79).)

## **SEC**

Ms. Thomsen identified the following current SEC enforcement priorities:

1. Options backdating;
2. Sweeps (as a continuing part of their ahead of the curve initiative);
3. Retail investors, including non-NASDAQ over-the-counter markets; and
4. Hedge funds.

She noted that the SEC wants to make sure it's everywhere, not just in the "hot" cases.

## **NASAA**

Among others, Mr. Borg identified the following issues as enforcement priorities for state securities regulators:

1. Senior education initiatives;
2. Variable annuities;
3. 506 Reg D problems;
4. Microcaps;
5. Oil and gas scams; and
6. Suitability and supervision.

## **Keynote Address**

Annette Nazareth delivered the keynote address which focused on the SEC's recent efforts to identify and prevent abuses with respect to the elderly. Her comments will be available in full at the SEC's website, [www.sec.gov](http://www.sec.gov).

## **Breakout Sessions**

### **Supervisory Issues for Broker-Dealers**

The panel began with a discussion of the issues surrounding NASD and NYSE Regulation Rules 3012 and 342.23, which requires its members to develop both general and specific supervisory control procedures. Grace Vogel, EVP of Member Firm Regulation at NYSE Regulation, said that from an examination standpoint, all firms had done a very good job of identifying high risk areas and were testing their systems more

thoroughly. Brian Underwood, SVP, Director of Compliance at A.G. Edwards & Sons, Inc., added that Rule 3012 has given firms the ability to drive home to the business units that they should test units to evaluate if risk controls are adequate in design implementation. Marc Menchel, EVP at NASD, said that the problem is that this process has become a “Herculean effort” because people are not distinguishing between what the rules require and whether or not a process is in place. He indicated that he is not sure that all of the efforts that have taken place are necessary. He explained that when a CEO signs a certification, she is only saying that a work plan is in place, and identifying who will implement the plan and the timeframe for the implementation. The CEO is not certifying that the system works.

Some other supervisory issues that were discussed were: back-office technology issues and the suggestion that back-office personnel who deal with clients should be licensed; firm’s duties regarding technology; and concerns about supervising producing managers. Also, there was some discussion about the frequency of branch examinations. Mr. Menchel noted that there is some flexibility in deciding the frequency of the exams. He added that it seems like the nomenclature of “OSJ” will disappear soon and will reemerge redefined.

The panel identified a few regulatory hot topics. First, as baby boomers get older, elder issues are coming to the forefront. Mr. Menchel said that one of the biggest challenges for the industry are people who have retired but have not saved wisely. Second, gifts and business entertainment are a hot issue. Third, there were 1,200 comment letters related to the rule filing for regulating sales of annuities. Mr. Menchel said that NASD has removed the disclosure piece of the rule and will make the supervisory requirement a little less onerous. The NASD will also add a carve-out if the trade was not recommended but the customer insisted he/she wanted to buy an annuity. Ms. Vogel added that NYSE Regulation would like to see an audit trail to show why there was a switch from one variable annuity to another. Mr. Menchel suggested that it would be worth the effort for everyone to look at its Notice to Members regarding life settlements (NtM 06-38) in order to understand how broadly NASD views best execution requirements.

## **The Examination Process From the Regulators' Perspective**

At a panel on the exam process, regulators offered the following priorities.

### **SEC Exam Priorities**

- **Supervision**
  - Written Supervisory Procedures
  - Branch Offices
  - Remote Offices
  - Outsourcing
- **Sales Practices**
  - Sales to Senior Citizens
  - 529 Plans
  - Variable Annuities
  - Illiquid Securities
  - IPOs
  - Fixed Income
  - Mutual Fund Breakpoints
- **Risk Management**
  - BCP
  - Back Office and Compliance for New and Complex Products
  - CSFTs
  - Information Security
  - Conflicts of Interests
- **Financial Issues**
  - Net Capital
  - Alternative Net Capital
  - Margin
  - Anti-Money Laundering
  - Foreign Accounts
  - SARs
  - CIP

- Compliance Programs
- **Books and Records**
  - Accuracy
  - Emails
  - Correspondence
- **Trading Practices**
  - Best Execution
  - Reg SHO
  - Confidential Customer Trading Information

#### **NASD Exam Priorities**

- Variable Insurance Products
- Mutual Fund Share Sales Practices
- Anti-Money Laundering
- Electronic Communications
- Branch Office Sales Practices
- Sales Seminars
- Private Securities Transactions
- Regulation S-P
- Heightened Supervision and Supervisory Controls
- New Products and Non-Conventional Instruments

#### **NYSE Regulation Exam Priorities**

- Anti-money Laundering
- Non-managed Fee Based Accounts
- Customer Privacy (Regulation S-P)
- Non-purpose Loans
- Internal Controls
- CEO Certification/Annual Compliance Report
- Supervision of Electronic Communications
- Investment Advisory Amendments (Section 202(a)-11)

- Operational Controls on Outside Investment Advisors
- Hedge Funds
- Indexed CDs
- Reg T Extensions
- Mark-Up/Mark-Down of Fixed Income Products
- Statutorily Disqualified Individuals and Member Organizations
- Use of Activity Letters
- New Products/Business Lines

### **Anti-Money Laundering**

Beverly Loew, Regulatory Policy Project Officer at the Financial Crimes Enforcement Network (FinCen), noted that FinCen has completed its rule making process for implementing the Patriot Act. She stated that the new framework has four major components: (1) a broad AML obligation for those entities involved in transactions, (2) identification of the customer, (3) risk-based due diligence for foreign accounts, and (4) a SARs reporting requirement for suspicious transactions. FinCen will now focus on issuing additional guidance in areas such as the interplay between the requirements under the new rules.

As part of the effort to provide guidance, there have been a number of recent announcements with regard to AML rule interpretations regarding CEO certifications, Customer Identification Programs, due diligence requirements, foreign bank certification and entities required to complete SARs. There will also be upcoming guidance on when clearing firms can rely on client information from an introducing firm. Ms. Loew identified the major themes to be discerned from the guidance are that the more direct relationship an entity has with a client, the more they need to know about the client, those entities involved at the beginning of a transaction are expected to know more about the transaction, and those entities that were involved closer in time to the beginning of the money laundering have a greater responsibility to detect it.

Ms. Angotti, Counsel at NASD, discussed cases brought for AML violations and noted that in the NYSE Regulation case involving Oppenheimer, the firm was cited for having only one full-time employee and one part-time graduate student monitoring the AML reports. She wanted to emphasize that a firm needs to devote sufficient resources to enforcing AML policies. As a standard, NASD will be evaluating in its examinations whether reports and alerts are answered in a reasonable period of time. In addition, Ms. Angotti said that a focus of upcoming NASD examinations will be indirect clients that have a direct business relationship with the broker-dealer such as a situation where the broker-dealer locates investors for a hedge fund client.

Ms. Angotti also emphasized that while general AML training is viewed positively by NASD, failure to assign tasks to specific people or failure to train employees charged

with AML tasks will be viewed as non-compliance with AML rules.

## **Fixed Income**

Mark Menchel from NASD stated that new NASD Rule 2320 removes the ambiguity about the definition of an order in the fixed income market by requiring best execution for all transactions with clients regardless of whether an order was received prior to the transaction. Mr. Menchel recognized that the debt markets differ from equity markets, but this difference is accounted for in the different factors that can be considered in determining the prevailing market price. Similarly, the rules do not change for illiquid securities, but NASD will be more willing to accept evidence such as price modeling to show the market price of a bond. However, he also cautioned firms that even under the new proposal, contemporaneous cost should still generally be the basis for markups. Mr. Menchel also advised firms that they will be in a better position with NASD in a markup investigation if they can show evidence that an order had terms other than price such as the client valued having the transaction completed quickly.

Another important change to the markup rules was the proposed exemption for transactions involving institutional customers. To qualify for this exception, (1) the client involved must qualify as a QIB under 144A, (2) the client must be able to evaluate the price of the bond and exercise independent judgment in the particular transaction, and (3) the security must not be investment grade. Mr. Menchel explained that this proposal also liberalized the rules that were announced in prior decisions by allowing firms to claim the market maker exception in fixed income transactions by showing that they meet the definition in the Exchange Act or meeting the requirements for a block positioner. A firm will not be considered a market maker, however, if it does not normally trade a particular security, even if it regularly trades in that sector.

Mr. Menchel reiterated NASD's position that it is not bringing markup cases at the margins. In an effort to respond to concerns about notice, NASD is considering releasing a Notice to Members that will announce the markup percentage on each type of security that could trigger a further review by the staff. He also emphasized that NASD would consider "commercial reality" in applying the markup rules. He encouraged the industry to focus on what is possible in terms of documenting price determinations rather than resisting enforcement of the rules.

In the realm of TRACE reporting, NASD is going to focus its efforts on making the report more efficient rather than expanding the number of securities covered.

Mr. Menchel noted that not every securities exchange has TRACE reporting and while it has benefited the retail markets, it is unclear whether transparency in the market helps institutional clients.

## **Conflicts of Interest and Ethical Issues**

At an industry panel regarding Conflicts of Interest, Harry J. Weiss, a partner at Wilmer, Cutler, Pickering, Hale and Dorr, LLP, noted that underlying many of the scandals of the last several years – mutual fund revenue sharing, research analyst issues, market timing,

etc. – were conflict of interest issues. Colleen Graham, Managing Director and Regional Head of Compliance for the America at Credit Suisse, stressed the idea that firms need to create a culture of compliance where the most senior people are made aware of the importance of issues like conflicts of interest, and then spread that concern downward. Mr. Weiss noted that firms also need to teach senior management about fiduciary duty and what it means to breach that duty. Richard Rosen, a partner at Paul, Weiss, Rifkind, Wharton & Garrison, LLP, made the point that it's extremely important that firms have policies that are actually going to be followed.

Several ways to identify possible conflicts issues on an ongoing basis were discussed by the panel, including: (1) regularly surveying business people to get them thinking about conflicts issues; (2) creating ongoing governing structures, like risk committees, to deal with conflicts issues; and (3) having day-to-day surveillance, supervision and procedures that are very robust.

Also discussed was the issue of privilege as it relates to the monitoring and assessment of conflicts issues. As a part of that discussion, Mr. Rosen mentioned that though a firm has gotten counsel involved at the proper time and has documented counsel's advice, you have to assume a regulator will insist that the privilege be waived. Mr. Weiss noted that it is still important, however, to do the things that will maximize the firm's ability to claim privilege.