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Implementing Today's Regulations for Asset Managers and Brokers

Compliance Reporter

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In This Issue

VOLCKER RULE: KEY DATES

- **July 21, 2015:** Firms must establish a Volcker compliance program as soon as practicable, and no later than this date, unless they have received an extension
- **July 21, 2017:** Two additional 1-year conformance periods are available, for which firms must apply separately at least 180 days in advance, leading up to this date
- **July 21, 2022:** End of the additional up-to-5-year extension period for certain investments in illiquid funds, such as private equity investments

Suitability, Conflicts Loom Large For B/Ds In 2014

Compliance teams at broker/dealers are reexamining their systems, policies and procedures for handling suitability and conflicts of interest requirements amid continuing regulatory scrutiny that is set to loom large in 2014.

Suitability and conflicts were high on the agenda spelled out in the **Financial Industry Regulatory Authority**'s annual regulatory and examination priorities letter to firms at the start of this month. But even before then, professionals had seen the writing on the wall and have been working to ensure firms are in good shape.

Suitability

FINRA has in recent months reminded firms of its focus on ensuring firms meet the demands of Rule 2111, which took effect in July 2012 (CI, 6/28/2012). Among other things, the rule expanded the factors relevant to a suitability determination to include an investor's age, investment experience, time horizon, liquidity needs and risk tolerance. It also covers investment strategies, including recommendations to hold securities.

On the penultimate day of 2013, FINRA issued a notice in which it reminded B/Ds of their responsibilities when:

- Recommending a rollover or transfer of assets in an employer-sponsored retirement plan to an Individual Retirement Account

(continued on page 14)

Private Fund C/Os Face Volcker Fallout

Now that the long-awaited Volcker rule has been approved, private fund compliance departments should begin reviewing lists of investors and trying to determine how to facilitate the exit of those affected by the reform, industry professionals have cautioned.

The Dodd-Frank Act-mandated rule approved by five agencies in December includes a bar on banking entities making certain investments in or transactions with most hedge funds and private equity funds after the rule goes fully into effect in July 2015.

Compliance with the Volcker rule is expected to be one of the most daunting

(continued on page 15)

CFTC Takes Steps On Cross-Border Rules

The **Commodity Futures Trading Commission** has taken its latest steps toward creating a framework for applying Dodd-Frank Act-mandated swaps rules in a cross-border environment. This week's ***Compliance Clinic*** examines the CFTC's new comparability determinations, no-action relief and advisory. It's a topic that continues to cause headaches for both regulators and compliance officials at U.S. and non-U.S. firms, including some that don't even have operations in the country but have links with U.S. counterparties. This only adds to the already daunting challenges of preparing to comply with Title VII reforms.

(see Compliance Clinic, page 10)

Around The Industry

Overseas, And Over Here

Despite the seemingly inexorable rise of globalization in the financial services industry, it can sometimes seem as if the wonderful world of compliance and regulation is lagging behind when it comes to coordinating—and even paying attention to—developments in other countries.

Sure, there are bilateral memoranda of understanding for regulators to cooperate in specific areas. And there are collective efforts for authorities to work together, such as the **Basel Committee on Banking Supervision**. On the industry side, major international firms sometimes assign global chief compliance officers and try to align their efforts in different jurisdictions. But there are also continuing disputes over issues such as how to match up derivatives reforms to avoid regulatory arbitrage, and sometimes among professionals there is a distinct lack of interest in or knowledge of overseas rules and supervisory trends.

That said, 2014 just might mark a watershed or turning point—or perhaps a less pronounced change—in this state of affairs. For one thing, regulators in the U.S. and elsewhere are fast approaching a crunch point for figuring out how new swaps rules fit together. As this week's *Compliance Clinic* examines (see page 10), the **Commodity Futures Trading Commission** is taking the lead in spelling out how it believes Dodd-Frank Act-mandated regulations should apply in the cross-border context.

Not only the **Securities and Exchange Commission** but non-U.S. supervisors will need to respond. In the meantime, many industry professionals view getting to grips with Title VII of Dodd-Frank as one of their top challenges for the year ahead, and say the uncertainty over the cross-border reach of the CFTC's regime only adds to their concerns (CI, 12/19).

At the same time, a key issue for U.S.-based investment managers and their CCOs in 2014 will be how to address the EU Alternative Investment Fund Managers Directive (CI, 12/19). Non-EU based managers will have to make the decision as to whether to comply or opt out of the costs, and business opportunities, of doing so.

On the other side of the world, new **Australian Prudential Regulation Authority** regulations may pose a similar dilemma for U.S. private fund or fund-of-fund managers wanting to manage the large pool of Australian superannuation funds (see story, page 8).

Despite their differences on policy issues, regulators are also quick to argue that they are making strides toward greater cooperation on enforcement and investigations. Highlighting this trend, the *Financial Times* reported in late December that the U.K. **Financial Conduct Authority** was on target to have received a record number of requests for help from overseas supervisors in 2013. According to the figures cited by the newspaper, the FCA received more than 1,000 international requests for assistance last year, with a rush of requests expected on the last day of 2013—a 17% jump from the total the previous year.

As the *FT* noted, this trend can be attributed at least in part to the influence of investigations such as that into the London interbank offered rate, in which operations in a variety of jurisdictions have come under scrutiny. It also underlines the need for firms to coordinate their cross-border compliance efforts. If the regulators are talking to each other across the oceans, it only makes sense for CCOs to be doing the same with their colleagues in London and beyond.

As always, please let me know if you have any comments or questions.

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Institutional Investor Intelligence

Broker/Dealer

JPMorgan B/D Fined $175K In Settlement Systems Case

JPMorgan Securities has settled allegations that it had settlement system problems that led to reporting issues, and related claims concerning its supervisory review systems.

The New York-based broker/dealer agreed to be censured and pay a $175,000 fine to settle the **Financial Industry Regulatory Authority** proceeding. FINRA has accepted a letter of acceptance, waiver and consent from the firm, in which the B/D did not admit or deny wrongdoing. A JPMorgan spokesman declined to comment.

According to FINRA, between September 2008 and April 2009 the firm's settlement system did not account properly for the cancellation of certain forward settling transactions. This, the self-regulatory organization said, caused incorrect data to be fed to the firm's sub-ledger and Financial and Operational Combined Uniform Single (FOCUS) reports. As a result, JPMorgan Securities filed an inaccurate FOCUS Report for the period ending Jan. 31, 2009 and maintained erroneous books and records, FINRA said.

In addition, FINRA alleged that the firm's fixed income settlement system did not reconcile with the firm's general ledger for hedging portions of two of the firm's high yield index bond books. These portions of the books were also not captured in the B/D's risk management system, but were incorrectly captured in the risk management infrastructure of a firm affiliate, according to the SRO. As such, the firm's value at risk (VaR) calculation was overstated as of Jan. 31, 2009, FINRA said.

Certain firm equity to credit (E2C) positions were not included within the firm's VaR calculation, according to FINRA. Instead, the SRO said, those E2C positions were incorrectly reflected in the VaR calculation for a different affiliate of JPMorgan Securities.

In addition, FINRA said the firm failed to establish and maintain adequate supervisory review systems during the period at issue. Specifically, it alleged, JPMorgan Securities failed to:

- Monitor for mismatches between its balance sheet and off-balance sheet in accounting the cancellation of its forward settling transactions;
- Monitor to ensure positions were mapped to the correct legal entity;
- Maintain an adequate exception report to detect the discrepancies between its various internal records

In regards to the last of these points, for example, FINRA said the firm relied on a daily exception report—referred to as the reconciliation report—to illustrate data flow issues between a front office system and a settlement system. According to FINRA, the reconciliation report was generated daily by the firm's middle office system. A comparison between original source data files from the front office system and data in a firm settlement system revealed that there were eight discrepancies in the two position records, the SRO said. Nonetheless, the firm's reconciliation report for Jan. 30, 2009 failed to capture these position breaks, according to FINRA.

Branch Registration

Planned Space Sharing Questions Spark Concerns

Industry groups have expressed concern over **Financial Industry Regulatory Authority** plans to revamp its branch office registration form, or Form BR. The groups say the self-regulatory organization has underestimated the compliance burden of reporting details of space sharing arrangements.

FINRA has proposed amending Form BR to nix Section 6, which at the moment applies only to **New York Stock Exchange**-registered firms. Among other things, the plans would add questions relating to space sharing arrangements and the location of books and records that at present are only in Section 6 and make them applicable to all members.

For example, the SRO has proposed adding a new question to the updated Form BR that would ask members to disclose if the branch office occupies, shares space with or jointly markets with any other investment-related entity, and if the answer is yes, to provide the name of such entity. "FINRA believes applying the space sharing arrangement question to all members will allow regulators to better understand the specific activities occurring at each registered branch office and monitor that such arrangements are structured in a manner that allow[s] public customers to identify the entity with which they are conducting business," officials wrote in a related filing.

In a recent comment letter, the **Financial Services Institute** said it was worried about the new space sharing questions. Such arrangements are not uncommon for independent brokers, FSI said, adding that they may include several different "doing business as" entities. Different DBA businesses and entities may be changing frequently, which may create difficulties for firms in constantly updating and monitoring this information for purposes of filing Form BR, FSI said.

"Because clients do not view Form BR information, and the information provided in the proposed changes can be obtained by regulators during a scheduled examination and interview, FSI believes the burden of providing this information is not outweighed by any benefit to investors or regulators," the group said.

Attorneys with **Sutherland Asbill & Brennan**, writing on behalf of the **Committee of Annuity Insurers**, raised similar concerns in a separate letter. "FINRA has underestimated the challenges and expenses certain firms such as insurance-affiliated [broker/dealers] would face to accurately and efficiently disclose the insurance entities with which they have entered into space sharing and joint marketing arrangements," the lawyers wrote. "In the Committee's experience, information regarding space sharing arrangements of the type contemplated by Section 4 is not readily maintained by insurance-affiliated and other types of member firms."

The Committee also believes the revised Form BR is unclear as to the scope of the proposed obligation for B/Ds to identify insurance entities with which they jointly market products, the Sutherland attorneys wrote. For example, they said, it is unclear whether the form is focusing solely on joint marketing (and space sharing) with insurance intermediaries such as insurance agencies, or also insurance product issuers

In a third comment letter, **Public Investors Arbitration Bar Association** President **Jason Doss** said his group supported the proposal and the inclusion of details in the proposed form as to space sharing arrangements and locations of office records. But he lamented that the plan would not impose a demand that firms submit the revamped Form BR by a certain date. "The current proposal builds in potential problems because it relies on member firms to determine when and if information has become inaccurate or incomplete," Doss wrote. "This vague standard invites unnecessary problems."

FORM BR PROPOSALS

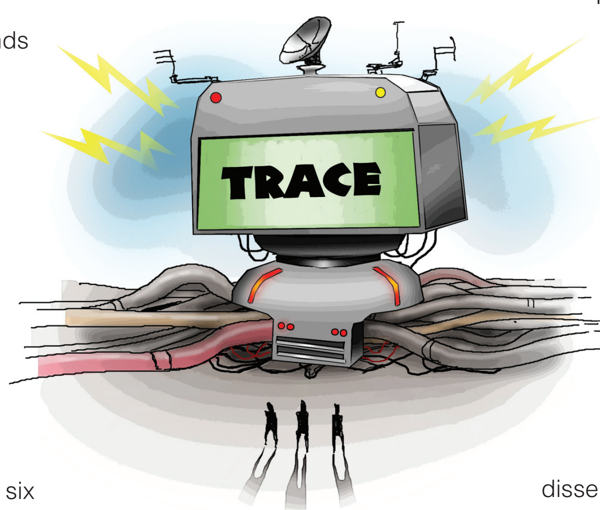
FINRA is proposing to amend Form BR to:

- Eliminate Section 6, applicable at present only to NYSE-registered firms
- Add questions relating to space sharing arrangements and the location of books and records that are at present only in Section 6 and make them applicable to all members
- Modify existing questions and instructions to provide more detailed selections for describing the types of activities conducted at the branch office
- Add an optional question to identify a branch office as an "office of municipal supervisory jurisdiction"
- Make other technical changes to adopt uniform terminology and clarify questions and instructions

SIFMA Frets ABS Dissemination Plan

The **Securities Industry and Financial Markets Association** is concerned about **Financial Industry Regulatory Authority** plans to disseminate a wider range of securitization transactions, arguing they would hit market liquidity and over-extend the definition of asset-backed securities.

The self-regulatory organization intends to amend the Rule 6700 Series and the Trade Reporting and Compliance Engine (TRACE) dissemination protocols to disseminate additional ABS transactions by re-naming as "securitized products" the broader group of securities defined as ABS. The plan also includes redefining ABS more narrowly to describe a specific class of securitized products (see box). At the same time, the plan would implement shorter reporting periods for such securities—45 minutes for the first six months, then fifteen minutes—as well as real-time dissemination of trade information.



FINRA believes the proposed additional price transparency in the ABS market will "enhance the ability of investors to identify and negotiate fair and competitive prices for [ABS]," officials wrote in a related filing.

Securitized products were the last major group of securities to be added to TRACE. In 2012, FINRA started disseminating transactions in agency pass-through mortgage-backed securities traded to be announced (TBA). In July 2013, it began disseminating agency pass-through MBS and **Small Business Administration**-backed ABS traded in specified pool transactions. The SRO is continuing to review whether to propose that collateralized mortgage obligations and agency-backed commercial mortgage-backed securities be disseminated, officials wrote.

In a recent comment letter, SIFMA said it is concerned that "negative impacts of price dissemination" that have affected the high-yield bond, TBA and specified pool markets will also hurt the proposed classes of ABS. "Both our buy- and sell-side members have consistently noted impairment of liquidity in the TBA MBS markets since dissemination was introduced in 2012 and we have raised these concerns to FINRA staff," the industry group said.

Members believe disseminating trade information for TBAs has contributed to an overall decrease in market liquidity, due largely to a decrease in the willingness of market makers to take on risk, SIFMA wrote, adding, "Market makers are less willing to take on large trades from their buy-side counterparties when the identity of their position becomes immediately known." The benefits of improvements to price discovery have been outweighed by the cost of decreased liquidity, the group argued.

Among other things, SIFMA said including collateralized debt obligations, collateralized loan obligations and non-agency-backed CMBS is "pressing the revised definition of ABS beyond what is appropriate." The group argued, for example, that most CDOs are backed by residential mortgage-backed securities or other mortgage assets, not ABS. "RMBS are not included in this proposal for dissemination, and we believe that re-securitizations of RMBS should be treated as analogous to RMBS, not consumer ABS, since the credit analysis required incorporates the analysis required on RMBS with the additional complexity from the nature of the transaction as a resecuritization."

COMPLIANCE PRIMER

Redefining ABS

As redefined in proposed Rule 6710(cc), an ABS would be:

"A type of securitized product where the [ABS] is collateralized by any type of financial asset, such as a consumer or student loan, a lease or a secured or unsecured receivable, but excludes: (i) an agency pass-through [MBS]…traded [TBA]… or in a specified pool transaction…; (ii) an SBA-backed ABS… traded TBA or in a specified pool transaction; and (iii) a collateralized mortgage obligation."

Insurance Company Help

SEC Grants B/Ds Relief On AWOL Clients

Broker/dealers got a compliance Christmas present in late December when the **Securities and Exchange Commission** agreed to let them outsource to certain insurance companies work involved in tracking down missing customers.

Rule 17Ad-17(a)(l) requires specified registered entities to exercise reasonable care in ascertaining the correct addresses of lost security holders and to conduct certain database searches for them (see box). Under the Dodd-Frank Act, the Commission last year amended Rule 17Ad-17 to make the requirements to search for security holders applicable to B/Ds.


Holly Smith

With the compliance date looming on Jan. 23, **Sutherland Asbill & Brennan** Partner **Holly Smith** wrote to the SEC on behalf of the **Committee of Annuity Insurers** requesting no-action relief. "We believe that Rule 17Ad-17 should be read to permit an insurance company, acting on behalf of a broker or dealer that has customer security accounts that include accounts of lost security holders, to conduct database searches for lost security holders in cases where the insurance company sends items of correspondence to the [B/D's] customers, on behalf of the [B/D]," Smith wrote.

Allowing an insurance company to act on behalf of a B/D in this way would be consistent with past SEC guidance allowing them to do so as a ministerial function, Smith wrote. "We believe the Committee's request makes sense for practical reasons, i.e., if an insurance company mails certain items of correspondence, it is highly likely that an item of correspondence that is not successfully delivered to the selling firm's customers will be returned to the insurance company, not the [B/D] on whose behalf it was mailed," she added. "If an insurance company then had to transfer that item to the [B/D] so that the database searches required by Rule 17Ad-17 could be conducted, it is likely that the process of searching for the lost security holder would become less efficient and more costly, and could result in items of correspondence themselves becoming lost."

In response, the staff of the SEC's Division of Trading and Markets noted the "unique relationship between insurance company issuers of variable annuities and [B/Ds]," and agreed to grant the relief if such insurance firms conduct database searches for lost security holders.

The staff's position is conditional upon:

- There being a pre-existing relationship between the insurance company and the B/D
- The existence of a binding written agreement between the insurance company and the B/D requiring that all books and records related to searches for lost security holders that are maintained and held by the insurance company on behalf of and as agent for the registered B/D must be the books and records of the B/D. They must at all times be subject to inspection by the SEC, **Financial Industry Regulatory Authority** or other self-regulatory organization

Full and complete responsibility for compliance with Rule 17Ad-17(a)(l) remains with the B/D.

COMPLIANCE PRIMER

Lost Security Holders

Securities Exchange Act Rule 17Ad-17(b)(2) defines a lost security holder as a one:

"(i) To whom an item of correspondence that was sent to the security holder at the address contained...in the customer security account records of the broker or dealer has been returned as undeliverable; ...and (ii) For whom the...broker, or dealer has not received information regarding the security holder's new address."

PNC Unit Fined Over Non-Traditional ETF Supervision

PNC Investments (PNCI) has been fined $275,000 as part of a settlement of allegations that the firm did not have an adequate supervisory system and made unsuitable recommendations regarding non-traditional exchange-traded funds.

The **Financial Industry Regulatory Authority** has accepted a letter of acceptance, waiver and consent from PNCI in which the Pittsburgh-based broker/dealer agreed to be censured, fined and pay roughly $33,000 in restitution, without admitting or denying wrongdoing. The firm's counsel, **Nelson Boxer** of **Petrillo, Klein & Boxer**, declined to comment.

Leveraged, inverse and inverse-leveraged ETFs—referred to collectively as non-traditional ETFs—were among the instruments highlighted in a January 2012 FINRA notice to members on what the self-regulatory organization called heightened supervision of complex products. The SRO has maintained a close interest in the subject (CI, 1/23/12).

Leveraged ETFs aim to deliver multiples of the performance of the index or benchmark they track. Some non-traditional ETFs are inverse or short, which means they aim to deliver the opposite of the performance of the index or benchmark they track. Some are both inverse and leveraged.

In a related filing, officials noted that non-traditional ETFs pose certain risks not found in their traditional counterparts—including the risks associated with a daily reset, leverage and compounding—and that their performance over longer periods of time can differ widely from that of their underlying index or benchmark.

Despite this, FINRA alleged, PNCI supervised non-traditional ETFs the same way it supervised traditional ETFs and therefore from January 2008 until June 2009, when the SRO issued a regulatory notice, failed to establish a reasonable supervisory system and written procedures to monitor the sale of such instruments.

According to FINRA, the firm relied on its general supervisory procedures to supervise transactions in non-traditional ETFs during the period at issue. But PNCI's general supervisory system at the time was not sufficiently tailored to address the unique features and risks involved with these products, the SRO said. For example, FINRA said, during the period at issue PNCI did not create a procedure to address the risks associated with longer-term holding periods in non-traditional ETFs.

FINRA alleged that, before June 2009, PNCI failed to provide adequate formal training to registered representatives and supervisors regarding the features, risks and characteristics of non-traditional ETFs. The SRO also alleged that PNCI made unsuitable recommendations. According to FINRA, during the period at issue the firm allowed certain reps to recommend to customers a non-traditional ETF without performing reasonable diligence to understand the risks and features associated with it.

Investment Management

Fund CCOs Advised To Reinforce Servicer Relationships


Peter Guarino

Mutual fund chief compliance officers should strive to develop closer relationships with outside service providers, particularly in areas of keen interest for regulators such as valuation, according to **Peter Guarino**, a former asset management CCO and now v.p. at consulting firm **Cordium**.

"It's really important for fund CCOs to develop an active working relationship with the compliance person at the fund service providers," Guarino told *CI*. Fund CCOs should be sure to meet several times a year and in person with their outside counterparts and should request the regular completion of questionnaires to ensure they stay abreast of the servicer's activities, he said.

In particular, CCOs should be sure to keep the fund's board informed of interactions with service providers, Guarino said. Third-party firms will typically generate lots of reports about their activities and CCOs should both ensure they share that information with boards, and use the board as a resource to gather more information from service providers when needed, he said.

The **Securities and Exchange Commission** has been focusing heavily on areas, such as valuation, in which outside servicers may play a key role—increasing the importance for CCOs of staying on top of pricing services they may use, Guarino said. "They need to be more aware of valuation and how pricing agents are doing their jobs," he said. That means "having discussions with their portfolio managers who receive daily pricing reports and cash availability reports and things of that nature, because the [portfolio managers] are the ones that are seeing those on a regular basis" and may overlook slight variances in the value of securities, he added.

CCOs should take care to review the same data as their portfolio managers in assessing the effectiveness of their valuation procedures, Guarino said. "So if you don't have access to the underlying systems at the service provider, I would get credentialed and get access so you can see the same reports your [portfolio managers] may be seeing on a real-time basis."

COMPLIANCE TIP

CCOs should ensure they obtain access to the full set of pricing reports relied on by their firm's portfolio managers, in order to keep tabs on compliance with valuation policies.

Temporary Regime To Expire

Groups Request Swaps Margining Help

The looming expiration of a temporary swaps clearing regime will create major uncertainty for many asset management firms unless the **Securities and Exchange Commission** steps in to unify broker/dealers' clearing rules, according to industry groups.

In a December 2012 order, the SEC mandated that individual B/Ds and futures commission merchants (FCMs) each devise their own customer margin methodologies. The industry has operated under a temporary regime since the adoption of those rules, but that is set to expire on Jan. 30, 2014, prompting the **Managed Funds Association**, **Alternative Investment Management Association** and **American Council of Life Insurers** to push for permanent adoption of the temporary rules, rather than requiring B/Ds and FCMs to create their own models.

The expiration of the temporary clearing rules "will increase risk and impose undue costs on the buy side," the groups wrote in a recent letter. "We are therefore very concerned by [SEC staff] actions that continue to proceed without any regard for the adverse impact on, or views and comments of, investors that will be significantly affected."

The adoption of varying margin rules risks driving many buy-side firms from the swaps markets, as there will be little transparency regarding the models, making it impractical to manage capital under the array of differing rules, the groups said. "Few firms will decide to clear their single-name [collateralized debt securities] when the economic terms of such a decision are subject to uncertain and significant change," they added.

In contrast to the robust margin analytics and comprehensive transaction and market-wide data used by **IntercontinentalExchange**'s ICE Clear Credit in devising its methodology, the groups said, individual B/D and FCM models are "based on data sets that are much more limited, and accordingly are unlikely to be as robust and accurate."

Under the temporary rules, B/Ds and FCMs may collect the minimum required margin amount from customers calculated by the clearing agency, plus any amount required by **Commodity Futures Trading Commission** rules or deemed appropriate by the B/D or FCM based on counterparty risks.

THE BOTTOM LINE:

Industry groups warned the SEC that the expiration of a temporary clearing regime and adoption of individual margin rules for B/Ds and FCMs will create unnecessary uncertainty and risk for asset managers.

Texas IA Settles Qualified Client Action

Registered investment adviser **Jim Poe and Associates** (JPA) and **James Emory Poe**—the sole officer and majority owner of JPA—have settled **Securities and Exchange Commission** allegations that the firm neglected to obtain complete information from investors and consequently violated a bar on charging performance fees to non-qualified clients.

The respondents, which did not admit or deny wrongdoing, agreed to pay a $35,000 fine and be censured to settle the administrative proceeding. Poe did not respond to a request for comment. According to the SEC, the Fort Worth, Texas-based firm has reimbursed all non-qualified clients. In considering the settlement, the agency took into account prompt remedial actions undertaken by the respondents and their cooperation.

According to the SEC, between 2009 and 2011 JPA, at Poe's direction, improperly charged three private funds that it manages a performance fee for clients who did not satisfy the requirements of a "qualified client" under the Investment Advisers Act. Section 205(a)(1) of the Act bars IAs that are registered or required to be registered with the Commission from entering into advisory contracts or providing advisory services pursuant to contracts that provide for performance fees. Rule 205-3 provides that the provisions of Section 205(a)(1) don't apply if the client with whom the adviser is entering into such contract is a qualified client.

JPA and Poe failed to determine when the advisory contract at issue was entered into whether any investors satisfied the requirements of Rule 205-3 by being qualified clients, the SEC said. As a result, JPA charged all investors in its funds, including those who were non-qualified clients, a performance fee, according to the agency, which said that between 2009 and 2012 the firm received $637,843 in performance fees from investors who were not qualified clients.

However, the SEC said, changes to Section 205 under the Dodd-Frank Act in 2010 and other changes to Rule 205-3 that became effective in 2012 limited the extent to which the fees at issue were charged improperly. As a result, the firm received $610,762 in performance fees in violation of Section 205(a)(1), the Commission said.

Rule 205-3: Qualified Clients

Under revisions adopted in 2012, a fund client is qualified if:

- The client has at least $1 million under management with the adviser immediately after entering into the contract
- The adviser has a reasonable belief that the client has a net worth of more than $2 million at the time the contract is entered into

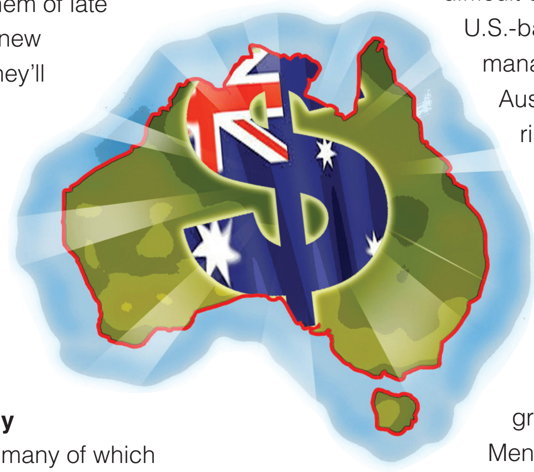
Oz Disclosure Rules To Entangle U.S. Managers

Private fund managers have had their work cut for them of late trying to figure out how and whether to comply with new EU marketing and disclosure rules (CI, 12/19). But they'll need to add another overseas jurisdiction's rules to their 2014 to-do list, as new regulations in Australia may potentially require portfolio-level performance reporting—something many managers are loathe to provide for fear of spilling proprietary strategies.

QUICK FACT

$1.6 trillion: The amount of assets in Australian superannuation funds.

The **Australian Prudential Regulation Authority** (APRA) last year released new reporting standards, many of which go into effect in July 2014. Of particular concern to U.S. managers are new rules for which regulators are now soliciting comment that may require portfolio information to be publicly available, **StepStone** Chief Compliance Officer **Jason Ment** told *CI*.



Australian superannuation plans comprise a fairly substantial pool of capital that U.S.-based firms may want to manage, so difficult choices may lie ahead for some U.S.-based private fund or fund-of-fund managers as to whether or not to manage Australian superannuation funds and risks bearing the brunt of the rules, Ment said. There are roughly AU$1.75 trillion ($1.56 trillion) in assets in superannuation funds, according to the most recent APRA statistics.

"In this interim period, it will be interesting to see how people grapple with that disclosure issue," Ment said. "Whether they elect to take the commitment and deal with the potential disclosure—or come up with some kind of structure to shield the disclosure" from the superannuation plan.

Challenges For 2014

PE Expenses On Regs' Radar, Attorney Warns

Jason Brown

Private equity compliance departments will need to attend carefully to fee and expense allocation procedures in 2014, as regulators have ramped up scrutiny in that area, according to **Ropes & Gray** Partner **Jason Brown**.

The **Securities and Exchange Commission**'s Office of Compliance Inspections and Examinations cited fund oversight as a target risk area among investment advisers when it published its exam priorities for the first time last year. While the SEC doesn't have specific guidelines as to what expenses an adviser can or cannot bill to the fund or clients, they do need to disclose thoroughly how charges are divvied up.

"The SEC has been diving deeply into all the expenses that have been paid by the fund or portfolio companies and whether those are consistent with the fund documents—especially in the private equity space," Brown told *CI*. PE firms must grapple with an additional layer of complexity in determining how to bill fund expenses, as it's not only the adviser, fund and clients that may be on the hook, but also a fund's underlying portfolio companies as well.

Firms have started responding to this heightened scrutiny and would be well advised to continue to bear it in mind in 2014, Brown said. Firms are "getting much more rigorous about [reviewing] how and what expenses are charged to the funds or to portfolio companies," particularly when it comes to items such as private air travel, Brown noted. Chief compliance officers should "make sure you have a process in place for understanding what should get charged and what shouldn't, and make sure it's consistent with fund documentation and disclosure," he advised.

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—Jason Brown, Ropes & Gray

Compliance Clinic

CFTC Takes Latest Steps On Cross-Border Issues

By Joshua Sterling and Akshay Belani, Bingham McCutchen

Joshua Sterling

Akshay Belani

On Dec. 20, 2013, the **Commodity Futures Trading Commission** announced additional steps in addressing the cross-border application of its swaps rules under the Dodd-Frank Act. These were in the form of a series of comparability determinations and no-action relief for swap dealers (and major swap participants) located in certain non-U.S. jurisdictions. (Because so few firms have registered as MSPs and for ease of presentation, we refer only to SDs throughout this article.) The comparability determinations apply to SDs located in Australia, Canada, the EU, Hong Kong, Japan and Switzerland. The no-action relief applies to SDs in these same jurisdictions except Hong Kong.

This relief came the day before the expiration of the CFTC's interim exemptive order issued on July 22, 2013 that, among other things, granted conditional relief to non-U.S. SDs and foreign branches of U.S. SDs in the above six jurisdictions from certain "entity level" swaps requirements.

The comparability determinations released do not address many of the "transaction-level" swaps requirements that apply to trades and trading relationships with non-U.S. SDs. The distinctions between entity-level and transaction level requirements were addressed in the CFTC's July 2013 cross-border guidance (see below).

On Jan. 3, 2014, three divisions of the CFTC staff jointly extended the expiration date of certain no-action relief that had been granted in connection with the issuance by one of those divisions of an advisory, in November 2013, that effectively imposed transaction-level requirements on non-U.S. SDs with respect to swaps with non-U.S. persons if the swaps are regularly arranged, negotiated, or executed by U.S.-located personnel or agents. That same day, the agency opened up a public comment period on the advisory.

Comparability Determinations, No-Action Relief

On Dec. 20, 2013, the CFTC released comparability determinations for non-U.S. SDs located in Australia, Canada, the EU, Hong Kong, Japan and Switzerland. The CFTC determined that entity-level requirements applicable to SDs under local law in each of those jurisdictions were comparable to and as comprehensive as those imposed under Dodd-Frank.

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The requirements covered by the comparability determinations include:

- Chief compliance officer responsibilities
- Swap data recordkeeping and reporting
- Risk management program
- Monitoring of position limits
- Diligent supervision
- Conflicts of interest policies and procedures
- Availability of information for disclosure and inspection
- Clearing member risk management

The CFTC also determined that certain transaction-level requirements applicable to swap dealers in the EU and Japan were comparable to those imposed under Dodd-Frank:

- For EU-located dealers, daily trading records, swap confirmation, portfolio reconciliation, portfolio compression and swap trading relationship documentation
- For dealers located in Japan, daily trading records and swap trading relationship documentation

The CFTC's findings as to the entity-level and transaction-level requirements noted above are subject to certain conditions and exceptions that are addressed in detail in the comparability determinations. Those conditions and exceptions must be considered carefully in assessing the full impact of the determinations on market participants.

In addition, the CFTC staff issued no-action relief from business conduct and swap data reporting requirements for certain non-U.S. dealers. The relief from business conduct requirements expires March 3, 2014. The relief from swap data reporting requirements expires March 3, April 2, or Dec. 1, 2014, depending on the specific reporting requirement and whether the non-U.S. counterparties are guaranteed affiliates, or conduit affiliates, of a U.S. person.

Status Of Other Requirements

The CFTC's comparability determinations and no-action letters do not address many of the transaction-level requirements that may apply to trades and relationships between non-U.S. SDs and their counterparties, such as real-time public reporting, clearing, trade execution and segregation of initial margin. How these requirements apply across borders was addressed in the CFTC's July 2013 guidance:

- For a "U.S. person" counterparty, transaction-level requirements generally apply to swaps and trading relationships with a U.S.-based SD, the foreign branch of a U.S.-based SD and a non-U.S. based SD
- For a "non-U.S. person" counterparty, the requirements generally apply to trades with U.S.-based SDs and foreign branches of U.S.-based SDs. Substituted compliance is available with respect to trades with foreign branches, as determined by the CFTC. Except as explained below, the requirements generally would not apply to trades with non-U.S. based SDs

Cross-Border Advisory: Recent Activity

As noted above, on Nov. 14, 2013 the CFTC staff issued an advisory that effectively imposes transaction-level requirements as to swaps between non-U.S. SDs and non-U.S. person clients that are regularly arranged, negotiated or executed by personnel or agents of the SD who are located in the U.S.

In effect, the advisory imports a conduct test into what had otherwise generally been an entity test under the July 2013 guidance. On Nov. 26, 2013, the staff issued a no-action letter indicating that it would not recommend an enforcement action against a non-U.S. dealer for failing to adhere to those requirements in the manner described by the advisory before Jan. 14, 2014.

The advisory, coupled with other actions by the staff around that time, led industry groups to file a lawsuit on Dec. 4 challenging the July 2013 guidance. At its core, the lawsuit alleges that the CFTC did not follow appropriate administrative procedures in issuing the July 2013 guidance, the November 2013 advisory and other measures touching the cross-border application of the swaps provisions. A hearing on a motion for summary judgment in the case is currently scheduled for Jan. 14 of this year. A CFTC spokesman did not respond immediately to a request for comment on the lawsuit.

On Jan. 3, the CFTC staff issued a letter extending its earlier no-action relief to Sept. 15, 2014. That same day, the agency announced it would give the public 60 days to comment on the staff's November 2013 advisory. The no-action relief and public comment request are designed to work in concert, meaning that—while the advisory remains under review and the relief remains in place—the staff will not recommend that the CFTC take enforcement action against a firm based on the approach to transaction-level requirements described in the advisory.

What's Next?

The CFTC has moved aggressively to implement its cross-border guidance, and more aggressively still in issuing further pronouncements that purport to define the outer bounds of the swaps provisions it is charged with enforcing under Dodd-Frank. At the same time, many regulators—including the **Securities and Exchange Commission**—have yet to finalize their own cross-border rules and guidance.

The CFTC's cross-border approach is also at loggerheads in many respects with the SEC's proposal for applying the securities-based swap provisions of Dodd-Frank across borders. In this context, it seems natural for the CFTC's approach to be open to review and possible recalibration so soon after its adoption.

Much remains to be resolved, including the establishment of supervisory arrangements for SDs among the CFTC and other regulators. It will remain important for market participants to stay tuned for further developments in this space. Firms will need to ensure their trading relationships and compliance functions address swaps requirements that apply to their businesses as the guidance evolves and further requirements come into effect.

Joshua Sterling *is a partner in the Washington, D.C., office of* ***Bingham McCutchen****.* ***Akshay Belani*** *is a partner based in the firm's New York office.*

U.S. PERSON DEFINITION UNDER THE CFTC'S JULY 2013 GUIDANCE

(i) Any natural person who is a resident of the U.S.

(ii) Any estate of a decedent who was a resident of the U.S. at the time of death

(iii) Any corporation, partnership, limited liability company, business or other trust, association, joint stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in (iv) or (v)), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the U.S. or having its principal place of business in the U.S.

(iv) Any pension plan for the employees, officers or principals of a legal entity described in (iii), unless the pension plan is primarily for foreign employees of such entity

(v) Any trust governed by the laws of a state or other jurisdiction in the U.S., if a court within the U.S. is able to exercise primary supervision over the administration of the trust

(vi) Any commodity pool, pooled account, investment fund or other collective investment vehicle that is not described in (iii) and that is majority-owned by one or more persons described in (i), (ii), (iii), (iv) or (v), except any commodity pool, pooled account, investment fund or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons

(vii) Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in (i), (ii), (iii), (iv) or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity

(viii) Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in (i), (ii), (iii), (iv), (v), (vi) or (vii)

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. 2013	In 2012, the Division of Investment Management indicated that it would not recommend enforcement action against any registered investment company if the fund or its custodian placed and maintained cash and/or certain securities in the custody of the Chicago Mercantile Exchange or a clearing member that is a futures commission merchant registered with the Commodity Futures Trading Commission, for purposes of meeting CME's or a CME clearing member's margin requirements for certain interest rate swaps and credit default swaps cleared by CME. The Division has extended the no-action assurances until Dec. 31, 2014. It extended similar relief to ICE Clear Credit, LCH Limited and LCH.Clearnet.
SEC	Dec. 2013	In response to a request from the Committee of Annuity Insurers, the staff of the Division of Trading and Markets gave no-action relief in situations where a broker/dealer relies on an insurance company issuer of variable annuities, acting on behalf of the B/D, to conduct the database searches for lost security holders required by Securities Exchange Act Rule 17Ad_17(a)(l).
SEC	Dec. 2013	Issued a staff report to Congress on its disclosure rules for U.S. public companies, as part of agency's efforts to modernize and simplify disclosure requirements and reduce compliance costs for emerging growth companies.
Commodity Futures Trading Commission	Jan. 2014	Issued an extension to a time-limited no-action letter on the applicability of transaction-level requirements in certain cross-border situations.
CFTC	Jan. 2014	The CFTC and the Federal Energy Regulatory Commission signed two memoranda of understanding to address circumstances of overlapping jurisdiction and to share information in connection with market surveillance and investigations into potential market manipulation, fraud or abuse.
CFTC	Dec. 2013	Division of Market Oversight issued time-limited no-action relief relating to certain credit default swaps clearing-related swaps executed pursuant to a CDS settlement price process.
CFTC	Dec. 2013	Division of Swap Dealer and Intermediary Oversight issued no-action relief for certain futures commission merchants, swap dealers and major swap participants concerning annual reports of chief compliance officers.
CFTC	Dec. 2013	CFTC and Monetary Authority of Singapore signed a memorandum of understanding designed to enhance supervision of cross-border regulated entities.
CFTC	Dec. 2013	Division of Swap Dealer and Intermediary Oversight issued no-action relief regarding introducing brokers' compliance with certain financial reporting and capital computation requirements.
CFTC	Dec. 2013	Division of Market Oversight provided conditional no-action relief from limitations on execution methods for required transactions that involve basis risk mitigation services provided by a swap execution facility.
CFTC	Dec. 2013	Division of Swap Dealer and Intermediary Oversight issued no-action relief regarding swaps entered into by persons registered as floor traders.
CFTC	Dec. 2013	Division of Swap Dealer and Intermediary Oversight issued an advisory concerning commodity trading advisers and swaps.
CFTC	Dec. 2013	Issued time-limited no-action relief from certain entity-level internal business conduct requirements for certain swap dealers and major swap participants established under the laws of Australia, Canada, the EU, Japan and Switzerland.
CFTC	Dec. 2013	Division of Market Oversight issued time-limited no-action relief from certain requirements of Part 45 and Part 46 of the Commission's regulations, for certain swap dealers and major swap participants established under the laws of Australia, Canada, the EU, Japan or Switzerland.
Financial Industry Regulatory Authority	Jan. 2014	Released its 2014 regulatory and examination priorities letter.
FINRA	Dec. 2013	Issued a notice to remind firms of their responsibilities when: (i) recommending a rollover or transfer of assets in an employer-sponsored retirement plan to an Individual Retirement Account; or (ii) marketing IRAs and associated services.
FINRA	Dec. 2013	Issued a summary of decisions made at a recent FINRA board of governors meeting.
FINRA	Nov. 2013	Released an enhanced version of BrokerCheck that allows investors to more quickly access and more intuitively understand the professional background of investment professionals.
Municipal Securities Rulemaking Board	Dec. 2013	Launched an online survey of users of its Electronic Municipal Market Access, or EMMA, website to gain a better understanding of how EMMA is viewed in the marketplace and the extent to which users rely on it for market information. The deadline for participating in the survey is Jan. 8, 2014.
National Futures Association	Dec. 2013	Issued ballots for two contested elections in the commodity pool operator/commodity trading adviser category of the board of directors.
NFA	Dec. 2013	Issued request for public director nominations for NFA's board of directors.
NFA	Dec. 2013	Issued guidance on the annual affirmation requirement for those entities that are operating under an exemption or exclusion from commodity pool operator or commodity trading adviser registration.
Investment Industry Regulatory Organization of Canada	Dec. 2013	Issued annual consolidated compliance report, outlining key priorities to enhance industry standards.
Canadian Securities Administrators	Nov. 2013	With Ontario Securities Commission, published a brochure on working with a financial adviser designed to help investors understand what an adviser can do for them, what to look for in an adviser and how to make the most of the relationship.
Financial Conduct Authority (U.K.)	Dec. 2013	Released a quarterly consultation paper on proposed miscellaneous amendments to the FCA Handbook, including extending the ability of authorized fund managers and others to communicate electronically with unitholders, including through websites.
European Securities and Markets Authority	Dec. 2013	Issued an updated Q&A on the implementation of the European Markets Infrastructure Regulation. The Q&As clarify, for example, how exchange-traded derivatives should be reported to trade repositories.
ESMA	Nov. 2013	Published an updated Q&A concerning the guidelines on exchange-traded funds and Undertakings for Collective Investment in Transferable Securities issues.
ESMA	Nov. 2013	Published its European Common Enforcement Priorities for 2013 in regards to financial statements.

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)
Canadian Securities Administrators	North America	Disclosure enhancements to fund facts	Approved amendments to National Instrument 81-101 (mutual fund prospectus disclosure) including: (i) adding an explanation of the risk scale and the relationship between risk and losses; (ii) requiring a list of some of the specific risk factors that could impact a fund's returns; and (iii) including a comparison of the mutual fund's performance with a low risk investment.	Become effective Jan. 13.
Commodity Futures Trading Commission	North America	Customer funds	The CFTC is adopting new regulations and amending 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.	Become effective Jan. 13.
Investment Industry Regulatory Organization of Canada	North America	Order execution service	IIROC has published for comment proposed amendments and guidance to ensure consistent regulatory oversight of order execution service accounts as a form of third-party electronic access to marketplaces.	Comments due Jan. 13.
Municipal Securities Rulemaking Board	North America	Continuing education	The MSRB is requesting comment on a proposal that would require dealers of municipal securities to ensure their staff receive annual training.	Comments due Jan. 13.
Chicago Board Options Exchange	North America	Trades for less than $1	Filed with the SEC a proposal to extend its program that allows transactions to take place at a price that is below $1 per option contract through Jan. 5, 2015.	Comments due Jan. 13.
NYSE Arca	North America	Transactions below $1	Filed with the SEC a proposal to extend its program that allows transactions to take place at a price that is below $1 per option contract until Jan. 5, 2015.	Comments due Jan. 13.
CFTC	North America	Aggregation of positions	The CFTC published a proposal to modify Part 151 of its regulations regarding its policy for aggregation under its position limits regime for 28 exempt and agricultural commodity futures and options contracts and the physical commodity swaps that are economically equivalent to such contracts.	Comments due Jan. 14.
BATS Exchange	North America	Quoting rules	Filed with the SEC a proposal to amend rules related to the continuous quoting requirement applicable to market makers.	Comments due Jan. 14.
CSA	North America	Auditor oversight	The CSA requested comment on a proposal that would give regulators greater insight into situations where the Canadian Public Accountability Board has imposed significant remedial actions on an audit firm.	Comments due Jan. 15.
NYSE Arca	North America	ETP crowd participant program	Filed with the SEC a proposal to create a crowd participant program to incentivize competitive quoting and trading volume in equity trading permits.	Comments due Jan. 16.
CSA	North America	Oil and gas disclosures	The CSA is requesting comment on a proposed amendment to National Instrument 51-101 regarding standards of disclosure of oil and gas reporting issuers.	Comments due Jan. 17.
CFTC	North America	Registered futures association membership	The CFTC has introduced a proposal that would require all persons registered with the Commission as introducing brokers, commodity pool operators and commodity trading advisers to become and remain members of at least one registered futures association.	Comments due Jan. 17.
NYSE Arca	North America	Risk management	Filed with the SEC a proposal to offer risk management tools to allow equity trading permit holders to monitor and address exposure to risk.	Comments due Jan. 17.
BATS Exchange	North America	Volatility closing auction	Filed with the SEC a proposal to amend rules governing auctions conducted on the exchange for exchange-listed securities.	Comments due Jan. 17.
New York Stock Exchange	North America	Risk management	Filed with the SEC a proposal to change rules to offer risk management tools to allow members to monitor and address exposure to risk.	Comments due Jan. 17.
Nasdaq Stock Market	North America	Acceptable trade ranges	Filed with the SEC a proposal to delay the implementation of a rule related to the Acceptable Trade Range.	Comments due Jan. 17.
Nasdaq	North America	System securities	Filed with the SEC a proposal to modify the definition of system securities in NASDAQ Rule 4751.	Comments due Jan. 17.
CSA	North America	Distributing securities to existing security holders	The CSA has published for comment a proposed prospectus exemption that would, subject to certain conditions, allow issuers listed on the TSX Venture Exchange to raise money by distributing securities to their existing security holders.	Comments due Jan. 20.
Nasdaq	North America	Execution algorithms	Filed with the SEC a proposal to adopt a new options execution algorithm with priority overlays.	Comments due Jan. 21.
Securities and Exchange Commission	North America	Lost security holders and unresponsive payees	As required by the Dodd-Frank Act, adopted amendments to Rule 17Ad-17 to: (i) extend the requirements to search for lost security holders from only recordkeeping transfer agents to broker/dealers as well; (ii) add a requirement that paying agents notify unresponsive payees that a paying agent has sent a security holder a check that has not yet been negotiated; and (iii) add certain other provisions.	Become effective Jan. 23.
CBOE	North America	Supervision	Filed with the SEC a proposed rule change relating to supervision.	Comments due Jan. 23.

Suitability, Conflicts

(Continued from page 1)

- Marketing IRAs and associated services

"A recommendation concerning the type of retirement account in which a customer should hold his retirement investments typically involves a recommended securities transaction, and thus is subject to Rule 2111," officials said, adding that reviewing firm practices in this area will be an exam priority this year.

Last September, the self-regulatory organization issued a report summarizing its exam findings under the rule and highlighting effective compliance practices. Of the firms examined, officials said, most had updated policies, procedures and systems, trained staff and obtained additional customer investment profile information. But some had not taken a comprehensive approach to best ensure compliance with the rule. Among firms where FINRA found deficiencies, inadequate procedures for hold recommendations was the most frequent deficiency.

Many firms did a great deal of preparatory compliance work ahead of the July 2012 deadline. But attorneys say they are and have been helping B/D clients look at their suitability policies and procedures in recent months. FINRA's September report card triggered some revisiting of and changes to compliance programs, **Morrison & Foerster** Partner **Anna Pinedo** told *CI*.


Anna Pinedo

Separately, Morrison & Foerster Partner **Daniel Nathan** noted that FINRA can bring supervisory enforcement cases, for example involving sales of complex products, where a firm's procedures are not as robust as they should be—even if nothing has gone wrong. Suitability is the biggest risk in this area, he told *CI*, noting that firms should check both the suitability of a product itself and client suitability.

In FINRA's recent annual priorities letter, officials said examiners will this year focus on suitability issues including:

- The manner in which firms disclose material risks to investors and the policies and procedures surrounding those disclosures
- Concentrations in longer duration instruments, including bond funds with longer average durations, and high yield securities recommended to retail investors, particularly if those investors have near-term liquidity needs or a conservative investment profile
- Concentrations in speculative equities positions in retail accounts

ON THE AGENDA

FINRA's 2014 regulatory and exam priorities letter highlighted topics such as:

- Suitability
- Recidivist brokers
- Conflicts of interest
- Cyber security
- Qualified plan rollovers
- Initial public offering market
- General solicitation and advertising of private placements
- Municipal advisers
- Risk control documentation and assessment

Conflicts

FINRA has also put firms on notice to be careful of how they handle conflicts of interest. In October, the SRO issued a report in which it highlighted effective conflicts management practices that officials noted "may go beyond current regulatory requirements and identify potential problem areas."

The initiative had earlier involved a series of face-to-face meetings between FINRA staffers and compliance officers and business executives from 14 B/Ds to discuss how they identified and managed conflicts of interest. "While many firms have made progress in improving the way they manage conflicts, our review reveals that firms should do more," FINRA Chairman and CEO **Richard Ketchum** said in a statement accompanying the report.

Despite the problems identified by the SRO, senior compliance officials and attorneys have welcomed what they describe as a useful roadmap for firms to follow. For example, **Gregory Johnson**, head of compliance for **JPMorgan Chase**'s global corporate and investment bank, in October said the paper had been well prepared. It is clear that disclosure is not a cure-all for conflicts of interest, he said, adding that instead there needs to be disclosure that is understandable to clients depending on their level of sophistication—similar to suitability considerations.

In the section of the new priorities letter dealing with conflicts, FINRA said its examiners this year will, among other things:

- Evaluate firms' conflicts management practices to help further inform the SRO's view on industry practices by focusing primarily on actions taken by firms and the impact on their clients
- Explore topics addressed in the October report including firms' approaches to identifying and managing conflicts, and the participation of senior management in this process
- Firms' approaches to conducting new product reviews to identify and mitigate potential conflicts. They may also inquire about post-launch reviews to assess product performance

Morrison & Foerster's Pinedo said the report had sparked requests to assess the policies and procedures firms have in place and whether they need to be bolstered.


Glen Barrentine

Glen Barrentine, a former chief regulatory officer of the **American Stock Exchange** and now partner with **Winston & Strawn**, told *CI* recently that firms were still at the review stage—though he expected there to be some tinkering and beefing up of practices in some cases. "You go forward at your peril if you have one of the business models [highlighted] in the FINRA report and you don't check whether you need to change your conflicts framework," he added. ***—Ben Maiden***

Private Fund *(Continued from page 1)*

tasks facing brokerage firms in the year ahead (CI, 12/19). Chief compliance officers in the asset management sector that spoke with *CI* said they had been slower to get up to speed on the 954-page rule than their brokerage counterparts, but the scope of the regulations is such that private fund managers won't escape unscathed.

"If you're a fund sponsor, you're going to want to look at your investors that may be banking entities subject to the Volcker rule and look at the terms and conditions for things such as exiting the fund and transferring those investors' interests," **Ropes & Gray** Partner **Mark Nuccio** told *CI*. "Larger fund sponsor organizations, in particular, are going to be compiling inventories of investors who they think may be subject to the Volcker rule and may have issues they need to deal with."


Mark Nuccio

"From a compliance perspective, third-party investment managers would probably want to look at their current investors—who they are and whether they have potential Volcker rule issues that would require them to take some action," **Debevoise & Plimpton** Partner **Satish Kini** told *CI*. "For instance, do they have banking entities that are currently investors and, if so, will those banking entities need to redeem or transfer their interests?"

Assessing Existing Investors

Investment managers "should be going through the list of all the investors in your funds and making sure that you've identified those investors that may be affected by the rule and the size of their investments. You should probably also be in contact with the banks, and start a dialogue with them," **Davis Polk & Wardwell** Partner **Yukako Kawata** told *CI*. "The important thing is to be prepared for what the banking entity investors will be asking for."


Yukako Kawata

In many fund documents, "it's fairly typical to see broadly worded provisions in funds created before Dodd-Frank that say that if the investment causes the investor a regulatory problem, the fund will be able to offer some sort of recourse to address the problem," Nuccio said. After Dodd-Frank became law, many funds began to tailor more specific provisions to address investors' potential concerns about the impact of the Volcker rule, including transfer and exit rights, he added. "So if you're a sponsor you'll want to be looking at those documents and developing a strategy for addressing the anticipated needs of those investors."

Fund managers will also want to pay attention to where investors are located as "if some of [a fund's] investors are foreign banking organizations, there are various ways in which such organizations may be able to invest in the fund notwithstanding the Volcker rule," Debevoise's Kini said. "So it may be possible to reorganize or restructure fund investments to fit within the Volcker rule for certain types of banking entities."

Private Equity

While hedge fund firms may be grappling largely with investors looking to withdraw or restructure investment, the private equity industry may have unique considerations. "The response may be different for private equity funds, where the interest is an illiquid interest," Kawata said.

"If the fund existed as of May 1, 2010, it may be an illiquid fund that gets a longer conformance period under the rule, which provides for extensions of up to five years for illiquid funds," she said. "The longer conformance period could mean that the bank may not need to exit the fund at all, because by the time the conformance period is done the fund may be about to wind itself up anyway."

PE funds should also be aware of limits on banking entity investments, whereby a banking entity may not take more than 3% percent ownership interest in a covered fund, **Sutherland Asbill & Brennan** Partner **Brian Barrett** told *CI*. If a banking entity's investment in a hedge fund or PE fund currently is greater than the 3% fund limit, the entity will seek to bring its investment into compliance by the end of the conformance period, he said. "The banking entity would typically seek redemption of the necessary amount of its investment and perhaps restructure the investment."

In addition to gearing up for the final Volcker rule compliance date, fund managers are still hoping for more guidance from regulators about structural alternatives that might enable them to accommodate investors within the regime. "One thing people have discussed is whether you could establish a parallel fund that would split the investments of U.S.-based banking entities and non-U.S. investors that are eligible for Volcker rule exemptions," Nuccio said. "As we head toward the full compliance date in 2015, we should anticipate that the **Federal Reserve** staff will be providing additional guidance on questions like that, which would be really helpful."

—Peter Rawlings

VOLCKER RULE

IM To-Do List

Kini advised investment managers to take the following steps in figuring out how to grapple with the Volcker rule:

- Determine if you have banking entity investors, and if so what those investors might need to do and how they might react
- Look into whether there are restructuring alternatives
- If you're trying to raise money and soliciting banking entity investors again, look into what structures it might be possible to set up to allow such investments under the rule

They Said It

*"You go forward at your peril if you have one of the business models [highlighted] in the [**Financial Industry Regulatory Authority**] report and you don't check whether you need to change your conflicts framework."*—**Glen Barrentine**, partner with **Winston & Strawn**, on the regulatory and compliance focus on conflicts of interest (see story, page 1).

One Year Ago In Compliance Reporter

Chief compliance officers at broker/dealers had received relief on the **Financial Industry Regulatory Authority**'s new suitability rule. FINRA guidance made clear that the rule would apply only when a B/D or registered representative makes a recommendation to a potential investor who then becomes a customer. [The **Public Investors Arbitration Bar Association** argued recently that changes to the "Investment Company and Variable Contracts Products Representative"—known as the Series 6—examination should go further in focusing on suitability issues to promote investor protection (CI, 11/20).]

Five Years Ago

A coalition of options exchanges criticized the **Securities and Exchange Commission**'s efforts to curb abusive naked short selling. They argued that an interim temporary final rule amending Regulation SHO that imposed close-out restrictions to prevent dramatic falls in stock prices had backfired. [SEC examiners have spotted options trading strategies that appear to evade certain requirements of Reg. SHO—and in a recent report outlined ways firms can keep an eye out for such activities (CI, 8/20).]

Tell Us What You Think!

Do you have questions, comments or criticisms about a story that appeared in *CR*? Should we be covering more or less of a given area? The staff of *CR* is committed as ever to evolving with the markets and we welcome your feedback. Feel free to contact **Ben Maiden**, managing editor, at (212) 224-3281 or bmaiden@iiintelligence.com.