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Implementing Today's Regulations for Asset Managers and Brokers

Compliance Reporter

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FINRA To Issue Conflicts Guidance

Richard Ketchum

The **Financial Industry Regulatory Authority** plans to release guidance soon on how firms should handle conflicts of interest—potentially giving chief compliance officers in the brokerage industry a roadmap in an area the self-regulatory organization is targeting as a top priority.

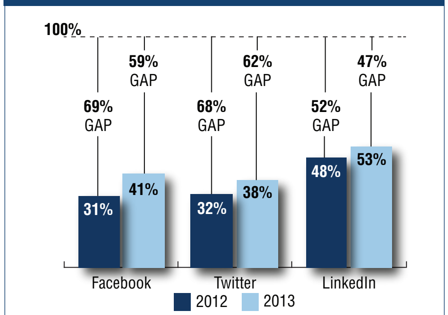
Speaking at a recent FINRA conference, Chairman and CEO **Richard Ketchum** said the SRO plans to "issue a report in early summer that outlines some strong conflict management practices." Last year, FINRA staffers sat down for face-to-face meetings with compliance officers and business executives from 14 broker/dealers to discuss how firms identify and manage conflicts of interest (CI, 10/25).

Ketchum said it is premature to discuss the SRO's findings in detail, but he gave broad hints as to items that may well feature in the report. Most of the firms FINRA interviewed said staff

(continued on page 19)

KEEPING TABS ON TWEETS?

Among firms with policies governing the use of social media, many still do not have an archiving/ supervision system in place to support the policies.



For more details, see story on page 13.

Source: Smarsh

FINRA Launches Latest Stage In ATS Review

The **Financial Industry Regulatory Authority** has taken the next step in its major review of alternative trading systems—sending targeted exam letters asking for detailed information about ATS that firms operate. The sweep letter, the second in less than a year on the topic, comes amid broad regulatory concern about market structure and related technological issues.

The Trading Examinations Unit of FINRA's Market Regulation Department is conducting the review and in the latest letter is delving

(continued on page 19)

Swaps Trading Rules: Tips For CCOs

The **Commodity Futures Trading Commission** last month approved long-awaited rules that will require many classes of swaps to be traded on organized facilities, including swap execution facilities (SEFs). Once the reforms go into effect, firms wanting to deal in swaps via a SEF or designated contract market will have to comply with a range of new trading activity requirements. This week's *Compliance Clinic* highlights some of the key points chief compliance officers should focus on in their preparations.

(see Compliance Clinic, page 14)

Around The Industry

Transatlantic Troubles

As unlikely as it may feel at times, chief compliance officers and regulators share a number of challenges in life. They both have to contend with limited budgets and those holding the purse strings who see them as simply imposing costs. They both have to tip-toe through a maze of complex instructions—Congress sends these down to regulators, who then send them down to CCOs. And, increasingly, both are facing added complexities in their work from cross-border influences, something that became even more apparent in May.

For example, **Bloomberg** reported last week that senior European regulators had written to **Commodity Futures Trading Commission** Chairman **Gary Gensler** urging him to extend a temporary exemption for overseas banks that is due to expire July 12. The EU wants the CFTC to hold off on imposing swaps rules on European firms while cross-border negotiations rumble on. An extension is necessary to "avoid any possible legal uncertainty and unintended consequences" from overlapping national rules, the Europeans reportedly wrote, pointing out that "EU firms would face huge legal and operational uncertainty."

This story highlights one of the "delights" for regulators arising from globalization: the need to balance not only a precarious set of interests within your own country, but to avoid regulatory arbitrage or protectionism that could make life even more difficult for firms and supervisors. This issue of *Compliance Reporter* (the biweekly publication from *Compliance Intelligence*) looks at some of these issues and how they affect the industry.

To start with, we report on a senior **Securities and Exchange Commission** official explaining and defending the agency's use of so-called "substituted compliance" in its plans for cross-border derivatives regulation (see story, page 3). The plan may help resolve questions for both U.S. and non-U.S. firms engaged in international transactions, but it has a long way to go before being finalized. Not only that, but the SEC and CFTC will have to align their differing approaches on the issue if further headaches are to be avoided.

After all, life can be much simpler for both regulators and firms if the rules of the road are the same in different markets. Knowing this to be the case, 10 trade groups have banded together to press the U.S. government to include financial services regulation in negotiations for the planned Transatlantic Trade and Investment Partnership (see story, page 5). The groups have a series of requests, including that there be "early consultations on significant regulations, use of impact assessments, periodic review of existing regulatory measures and application of good regulatory practices." No change there, at least.

Meanwhile, the EU Alternative Investment Fund Managers Directive looms large for U.S. hedge fund firms. Among other things, firms that market into the region have many questions about how the rules will affect them. With that in mind, the **Managed Funds Association** has asked the new U.K. **Financial Conduct Authority** to clarify and alter several marketing-related provisions (see story, page 7).

In another sign of how overseas regulation can bring fear to U.S. firms, the **Investment Company Institute** has urged the **International Organization of Securities Commissions** to avoid imposing new rules governing fund managers' use of financial benchmarks and indices (see story, page 7).

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

Best regards,
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Institutional Investor Intelligence

Broker/Dealer

Non-Conventional Instruments

VSR Fined $550K Over Supervision

VSR Financial Services has agreed to pay a $550,000 fine to settle allegations that it failed to establish, maintain and enforce a reasonable supervisory system regarding the sale of non-conventional investments and the use of consolidated reports. The **Financial Industry Regulatory Authority** also alleged that, through two of its representatives, VSR made unsuitable recommendations in such non-conventional investments.

The Overland Park, Kan.-based firm and its co-founder, **Donald Beary**, submitted a letter of acceptance, waiver and consent in which they agreed to settle the claims without admitting or denying wrongdoing. FINRA has accepted the AWC, under which Beary was also suspended for 45 days from associating with a member firm and fined $10,000. **Bryan Cave** Counsel **Jeffrey Ziesman**, who represented Beary and VSR, said the settlement speaks for itself and brings the matter to a close.

According to FINRA, from roughly July 28, 2005, to Aug. 19, 2010, VSR failed to have and enforce a reasonable supervisory system regarding the sale of non-conventional investments (see box). At the time in question, the self-regulatory organization said, VSR had written supervisory procedures, or WSPs, addressing suitability of non-conventional instruments, which it labeled "alternative investments," including private real estate programs, note programs, oil and gas programs, private equity/venture capital programs and managed futures.

> **COMPLIANCE PRIMER**
>
> **Unconventional Instruments**
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> **NASD** in November 2003 issued Notice to Members 03-71 to remind firms of certain sales practice obligations when selling non-conventional instruments. The notice defined such instruments as alternatives to conventional equity and fixed income investments, such as: asset-backed securities, distressed debt, derivative instruments and real estate investment trust programs.

The firm's WSPs provided that no more than 40% to 50% of a client's "exclusive net worth" could be invested cumulatively in alternative investments unless there was a major reason, FINRA said, adding that the firm, through Beary, created other procedures that applied a so-called "discount" to certain non-conventional instruments, thereby reducing the percentage of a client's liquid net worth invested. According to the SRO, the **Securities and Exchange Commission** in 2006 and 2008 found that VSR did not have adequate WSPs for the discount program, but the firm did not rectify the situation or stop the discount program.

FINRA alleged that the discount program artificially reduced the amount a client had invested in a particular product for the purposes of calculating concentration. It also alleged that, when calculating concentration at certain risk levels, VSR lowered the risk rating on numerous investments, making the ratings inconsistent with the risks stated in offering documents related to the instruments.

According to the SRO, VSR also failed from January 2006 through January 2012 to supervise the use of consolidated reports by its registered reps, resulting in inaccurate statements being sent to clients. The alleged violations had the effect of increasing the firm's sales of non-conventional investments, FINRA said. Between Jan. 1, 2006, and Sept. 30, 2010, roughly 20% to 45% of the firm's revenues were generated by the sale of non-conventional instruments, "increasing the seriousness of the violations," FINRA said.

In addition, the SRO alleged that, through two of its reps, VSR made unsuitable recommendations to six customers resulting in millions of dollars in customer losses, with the firm failing to supervise properly those reps in their sales of non-conventional instruments. One of the reps was not indentified in a related filing. The other, identified as **Michael Shaw**, was alleged to have recommended and effected the sale of high risk private placements to four clients that were unsuitable given their financial circumstances and condition. Among other things, FINRA said VSR did not detect or investigate red flags such as Shaw's alleged falsification of account documents.

According to a filing, Shaw settled a related action in late 2011, filing an AWC without admitting or denying wrongdoing. He was barred from association with member firms and could not be located for comment.

Cross-Border Regulation

SEC Official Backs Substituted Compliance

The use of so-called "substituted compliance" in regards to cross-border derivatives regulation would have the benefit of offering more flexibility and potentially helping avoid regulatory arbitrage, according to **John Ramsay**, acting director of the **Securities and Exchange Commission**'s Division of Trading and Markets.

The SEC last month proposed rules and interpretive guidance for cross-border security-based swap transactions. The proposal explains which regulatory requirements entities must comply with when a transaction occurs partially within and partially outside the U.S. It would also determine when security-based swap dealers, major security-based swap participants and entities such as clearing agencies, execution facilities and data repositories must register with the agency.

The proposal outlines a substituted compliance framework—a method by which participants in cross-border transactions would be able to substitute compliance with home country rules in place of the U.S. requirements if the SEC has determined those

What I like about the substituted compliance concept is that it recognizes that different regulatory regimes can have different ways of achieving the same outcomes.

—John Ramsay, SEC

home country rules to be comparable.

Some observers have said this approach may serve as a bridge between the **Commodity Futures Trading Commission**'s initial proposal from last summer, which sparked criticism from some overseas regulators who argue it is too extraterritorial.

Ramsay told delegates at a recent **New York City Bar Association** event that substituted compliance determinations would be made "considering the similarity of outcomes under each set of rules. This scheme would not involve a rule-by-rule comparison and would recognize that it is possible to get to the same place by more than one path." He noted that the agency would consider comparability according to four general categories:

- Regulation of non-U.S. dealers
- Regulatory reporting and public dissemination of trade data
- Mandatory clearing of security-based swaps
- Mandatory trade execution

Under the SEC plan, a group or market participant could request a substituted compliance determination for one or all of these categories on a jurisdiction-by-jurisdiction basis. Unlike with so-called "equivalence" assessments, Ramsay said, this would not be an all-or-nothing exercise—meaning for instance that the Commission might allow foreign participants to follow the capital and margin rules of their home country if they were found to be comparable, while requiring them to follow SEC transparency rules if their home regulator's rules are different.

The SEC proposal would enable clearing agencies, trade repositories and swap execution facilities to meet exemptions if their home countries are found to have comparable rules to those governing their equivalents in the U.S., Ramsay said. "So, for example, a trade between a foreign dealer and a U.S. fund that is required to be cleared under the U.S. regime could be cleared instead at a non-U.S. registered European clearing agency if that entity was subject to a comprehensive and comparable system of oversight in its home country," he added. "What I like about the substituted compliance concept is that it recognizes that different regulatory regimes can have different ways of achieving the same outcomes. More than that, it allows U.S. regulators to encourage continuing dialogue with our colleagues in other countries."

SEC Headquarters, Washington, D.C.

By contrast, Ramsay noted that equivalence assessments look at the full range of another jurisdiction's rules to determine whether they are comparable—if so, participants trading cross-border can choose which country's rules to apply. "One problem with this approach is that it requires an 'all or nothing' determination," he said. "If another regime is found to be comparable notwithstanding significant gaps in coverage, the markets are ripe for regulatory arbitrage, since participants will always opt for the lower-burden alternative." But if an equivalence assessment requires rules to be mostly identical, it will be very difficult to ever reach that decision, he added.

Morgan Keegan Settles Securitization Supervision Case

Morgan Keegan has settled **Financial Industry Regulatory Authority** allegations that supervisory weaknesses at the firm meant it failed to prevent a former senior trader from making fictitious securitization sales.

FINRA accepted a letter of acceptance, waiver and consent in which the Memphis, Tenn.-based firm agreed to be censured and pay a $60,000 fine to resolve the action without admitting or denying wrongdoing. **Olga Greenberg** of **Sutherland Asbill & Brennan**, counsel to the firm, did not respond to a request for comment.

According to FINRA, between February 2008 and April 2009 Morgan Keegan failed to establish adequate supervisory systems and written policies and procedures to ensure reasonable supervision of the head trader on the firm's small business administration (SBA) desk, which was part of the firm's fixed income business. During this period, FINRA said, the SBA desk bought U.S. government guaranteed small business loans from small regional banks that it then securitized and sold as pools to Morgan Keegan's institutional clients.

Beginning in or around spring 2006, the demand for SBA pools began to drop, the self-regulatory organization said. As a result, during the period at issue the SBA desk's inventory levels increased sharply and remained above the firm's allowable levels, FINRA said. In May 2008, the firm confronted the head trader, **Paul Francis Anton II**, about the SBA desk's excessive inventory levels and instructed him to sell a number of positions, according to FINRA. Instead, the SRO said, Anton manipulated the desk's inventory levels so they appeared to be lower than they were. During the relevant period, Anton entered four fictitious SBA pool trades totaling around $82 million as a result of which Morgan Keegan believed the SBA loan levels had decreased by a total of $75 million, FINRA alleged.

In addition, the head trader repeatedly manipulated forward the settlement dates, FINRA said. As the settlement date for each fictitious order approached, he moved it forward by 30 days to allow himself more time to sell the SBA pool, thereby triggering the creation of "cancel and correct" tickets for the four trades for several consecutive months, according to the SRO.

In April 2009, FINRA said, a back office employee at the firm who monitored funding of the SBA desk discovered a discrepancy in the SBA pools' reporting positions and told senior management. When confronted with the findings, Anton admitted his misconduct and was terminated by the firm, FINRA alleged.

According to the SRO, Morgan Keegan's supervisory systems and written supervisory procedures, or WSPs, for government loans, including SBA pools, were inadequate to prevent the head trader's alleged fictitious trading. Among other things, FINRA alleged that:

- The firm did not have a process to monitor SBA loans that were aged—i.e., more than 120 days old. While the firm's WSPs outlined a process to review aged inventory related to all other securities, they did not include a process to review aged and unsettled SBA pools
- The firm did not have a process to confirm and compare ex-clearing transactions, such as sales of SBA pools, or controls in place to review cancelled or modified transactions for reasonableness
- The firm's risk management structure did not adequately address the distinct duties of the front and back offices, in that the back office personnel who handled the administration of trades reported directly to the head trader. This structure caused the delay in the firm's detection of the alleged misconduct
- The firm inadequately addressed the marking of the SBA desk inventory positions because the WSPs required SBA pools to be marked on a monthly, as opposed to daily, basis

FINRA in 2011 accepted an AWC from Anton in which he agreed to pay a $10,000 fine and be suspended for six months from association with FINRA firms. He did not admit or deny wrongdoing. He represented himself in that action, is no longer registered with FINRA and could not be located for comment.

THE BOTTOM LINE:

FINRA said Morgan Keegan's supervisory systems and WSPs for government loans, including SBA pools, were inadequate to prevent the head trader's alleged fictitious trading.

Finance Wants In

Groups Outline Wish List For U.S.-EU Reg Pact

A coalition comprising 10 industry groups including the **Securities Industry and Financial Markets Association** has pressed the **National Security Council** to include financial services regulation in plans for a sweeping transatlantic trade deal.

The groups gave their support for the planned Transatlantic Trade and Investment Partnership, or TTIP, arguing that, "For the financial services sector, the TTIP should include conventional market access rules, as well as mechanisms and processes to achieve sound, efficient, compatible and cost-effective regulatory frameworks that facilitate access to capital and boost economic growth."

According to the groups, there is agreement among regulators, the industry and trade negotiators that traditional financial services trade and investment provisions should be included in the pact. "However, it concerns us that U.S. authorities appear to be reluctant to embrace the regulatory cooperation elements of the TTIP for financial services, despite the fact that they will likely be extended to virtually every other sector of the economy," they argued.

The other signatories to the letter were the: **American Council of Life Insurers**, **American Insurance Association**, **Coalition of Service Industries**, **Financial Services Roundtable**, **Financial Services Forum**, **National Foreign Trade Council**, **Property Casualty Insurers Association of America**, **United States Council for International Business** and the **U.S. Chamber of Commerce**.

They asked that negotiators discussing the processes, mechanisms and commitments relating to regulatory cooperation take into account certain aims. For example, financial services should be subject to the "cross-cutting disciplines" described in the final report, issued in February, of the High Level Working Group on Jobs and Growth, the groups said. The report recommended "early consultations on significant regulations, use of impact assessments, periodic review of existing regulatory measures and application of good regulatory practices," they noted.

The groups also asked that the TTIP "coordinate and strengthen the vast number of bilateral regulatory dialogues already in place or that might be created in the future," such as the U.S.-EU Financial Markets Regulatory Dialogue. In addition, the TTIP should make clear that governmental policy makers and regulators should boost compatibility, where appropriate through equivalence, mutual recognition or other agreed means, the groups said.

They countered suggestions that financial services should not be included within the scope of regulatory cooperation, arguing among other things that the TTIP would not interfere with broader discussions such as the G-20 and the **Financial Stability Board**. "Efforts within the TTIP, or in the future, to build understanding of how different regulatory systems can achieve equivalent regulatory outcomes or further efforts to bring about mutual recognition, substituted compliance arrangements or other mechanisms, will remain squarely in the hands of U.S. and EU government officials and financial regulators who will have to answer to Congress and are subject to statutory mandates," the groups wrote.

THE BOTTOM LINE:

Several trade groups have argued that the TTIP should include conventional market access rules, as well as mechanisms and processes to achieve sound, efficient, compatible and cost-effective regulatory frameworks.

MB Trading Settles Forex Compliance Case

MB Trading Futures, an El Segundo, Calif.-based retail foreign exchange dealer and futures commission merchant, has been fined $200,000 in settling allegations that it failed to comply with minimum financial requirements introduced under a Dodd-Frank Act-mandated reform.

Effective Oct. 18, 2010, the **Commodity Futures Trading Commission** adopted new rules designed to protect individual investors buying or selling forex contracts. Under the rules, RFEDs and FCMs that offer or engage in retail forex transactions must at all times maintain adjusted net capital of $20 million and hold enough permitted assets to meet or exceed their total retail forex obligations to customers (see box). The rules also impose restrictions on the types of funds firms can include in their adjusted net capital and asset computations.

According to the CFTC, during the period from the day the rules became effective until March 1, 2012, MB Trading included unsecured receivables accruing from over-the-counter forex transactions in four accounts in its adjusted net capital computations for the purposes of complying with Regulation 5.7(a). But unlike their parent companies, the CFTC said, the entities at which those four accounts were held are not among the regulated entities enumerated by Regulation 5.7(b)(2)(iii), meaning that unsecured receivables accruing from OTC forex transactions in those accounts must be excluded in any computation of adjusted net capital.

After excluding these funds from MB Trading's adjusted net capital, the CFTC determined that the firm failed to maintain the required level for 456 calendar days during the period at issue, despite otherwise being in compliance with its capital requirement.

In addition, during the relevant period MB Trading included funds held in two of the accounts discussed above in its asset computations for the purposes of complying with Regulation 5.8(a), the Commission said. Unlike their parent companies, the entities at which those two accounts were held are not among the qualifying institutions listed in Regulation 5.8(b), the agency said, adding that this meant the funds held in the accounts could not be considered assets for the purposes of Regulation 5.8(a).

According to the CFTC, the firm also improperly included funds it held in another account in its asset computations under Regulation 5.8(a). The funds in that account should not have been included because the funds were not sufficiently liquid, in that the entity holding that account could potentially delay the return of funds to MB Trading for more than one business day, the Commission said.

After excluding funds held in these three accounts from MB Trading's assets, the firm failed to maintain sufficient permitted assets under Regulation 5.8(a) for 501 calendar days during the relevant period, the CFTC said.

Having determined on or around March 1, 2012, that it could not include certain funds in its adjusted net capital computations or asset computations, the firm transferred those funds into proper accounts and notified the Commission of its capital and asset deficiencies the same day, the CFTC said. MB Trading also adopted enhanced written compliance procedures designed to ensure it would not violate Regulation 5.7(a) or 5.8(a) in future. The Commission took into account these remedial actions and the firm's cooperation in settling the action.

MB Trading agreed to settle without admitting or denying wrongdoing. In a statement, the firm said: "MB Trading currently meets or exceeds all of its regulatory capital requirements and has continued as it has for the past 11 years to meet its financial

COMPLIANCE PRIMER

Financial Requirements

Under the rules that came into force Oct. 18, 2010, RFEDs and FCMs offering or engaging in retail forex transactions must at all times comply with the following:

- Regulation 5.7, which requires such firms to maintain adjusted net capital of $20 million. For the purposes of calculating adjusted net capital, current assets must exclude unsecured receivables accruing from certain OTC forex-related transactions, or arising from the deposit of collateral or compensating balances with respect to such transactions, unless the unsecured receivable is from an eligible contract participant that is also among the regulated entities enumerated by Regulation 5.7(b)(2)(iii)
- Regulation 5.8, which requires such firms to hold assets solely of the type permitted by Regulation 1.25 in an amount equal to or exceeding its total retail forex obligation. Such assets must be held at one or more qualifying institutions in the U.S. or money center countries, as defined in Regulation 1.49

obligations…While the firm had no intention of transacting with entities that did not qualify, during the deficiency period, the firm had sufficient assets to comply with all requirements if the funds had been maintained with qualified entities." It added: "Management believes that no customer funds were at risk or negatively affected as a result of such deficiency."

Investment Management

MFA Seeks U.K. Fund Marketing Changes, Clarity

The **Managed Funds Association** has asked regulators to clarify and alter several marketing-related provisions of the EU Alternative Investment Fund Managers Directive.

In a recent letter, MFA asked the U.K. **Financial Conduct Authority** to change the test that determines an investor's home country. Funds marketed to investors deemed to be within the U.K. will be subject to certain restrictions and disclosures under the Directive.

At present, the rules state that the domicile or registered office of an investor will be used to make this determination. So, if a U.S.-based fund manager were to pitch its fund to a U.K.-domiciled investor living in New York, for instance, or to the New York branch of a bank incorporated in the U.K., that manager would be considered to be marketing in the U.K., MFA General Counsel **Stuart Kaswell** wrote. Determining an investor's location in this manner would be impractical for fund managers, particularly because the domicile definition varies among EU member states, he said.

Stuart Kaswell

The FCA should instead adopt a standard based on the investor's current residence, MFA argued: "We believe a test based on residence is more likely to achieve a consistent approach across EU member states and with respect to other jurisdictions, avoid an overly broad extraterritorial reach that could result in conflicts of law and provide greater certainty to market participants."

The group also asked the FCA to elaborate on its understanding of what constitutes marketing. MFA said it agreed with the Authority that a person offers its fund for the purposes of the Directive when it makes units of a fund available for purchase. But Kaswell asked the FCA "to clarify that the marketing of an [alternative investment fund manager's] capabilities is distinct from the marketing of any [alternative investment fund] managed by the AIFM." This would allow documentation that doesn't reference a particular fund and which is generic as to the manager's capabilities to be distributed to investors without falling under the scope of the Directive, since in that case no units of the fund are made available for purchase, Kaswell wrote.

MFA also asked the regulator to clear up its definition of passive marketing. A draft rule describes, as an example of passive marketing, communications responding to overtures from an investor with no prior knowledge of the fund and no previous involvement with the manager. This example "has led to much debate and uncertainty within the industry," Kaswell wrote.

In that example, an approach from an investor who was marketed to by a manager and invested in a fund before the July AIFMD deadline wouldn't be considered passive marketing, because of the investor's "previous involvement," he wrote. "It would be helpful for the FCA to clarify that the example is not intended to preclude any other form of passive marketing as long as such activity does not fall within the definition of 'marketing.'"

THE BOTTOM LINE:

Among other things, MFA asked the FCA to change the test that determines an investor's home country. Funds marketed to investors deemed to be within the U.K. will be subject to certain restrictions and disclosures.

ICI Frets Potential Benchmark Rules

The **Investment Company Institute** has urged international regulators to avoid imposing new rules governing fund managers' use of financial benchmarks and indices.

The **International Organization of Securities Commissions** recently published a consultation paper on the principles that ought to be applied to creating and using survey-based benchmarks and commercial indices. The report was prepared by a task force in what IOSCO said was a response to recent probes and enforcement actions involving alleged attempted manipulation of interest rate benchmarks.

While ICI agreed with the high level principles the Organization outlined, the fund industry group said the paper's authors "have not identified any concerns specific to [commercial] indices that warrant regulatory intervention." ICI said in a comment letter that it was "particularly concerned with the potential costs if IOSCO members took different regulatory approaches to encourage implementation of the principles, such that indexes used across multiple jurisdictions (as many are) could be subject to potentially conflicting regulations."

ICI also expressed concern that the data sufficiency principle described in the report might be ill-suited to assessments of fixed income securities (see box). In some instances, those instruments "trade so infrequently that the last transaction price may not reflect their current value," the group wrote. In such cases, fund managers and benchmark administrators may be better served studying actionable bids and offers and modeled price estimates, while also taking into account the potential limitations of non-transaction-based data, ICI said.

The fund group expressed support for IOSCO's efforts to reform the process for establishing survey-based benchmarks, such as the London interbank offered rate, by making the procedure more fact-based and transparent and improving governance over the calculations. ICI contended that changes aimed at improving, rather than replacing, survey-based benchmarks should be preferred, arguing that there are "practical implications of migration, such as the necessity of renegotiating existing contract to reflect the new rate, a process that would be protracted, consume significant resources and present serious operational challenges."

The IOSCO report comes in the midst of an uptick in the use of alternative indices in the exchange-traded fund and asset management industries. The **Financial Industry Regulatory Authority** recently issued its own guidance allowing exchange-traded product sponsors to use so-called pre-inception index performance data in communications with institutional investors (CI, 4/29).

IOSCO BENCHMARK PRINCIPLES

Data Sufficiency

The Organization said information used to construct a benchmark should:

- Be based on prices, rates, indices or values that have been formed by the competitive forces of supply and demand in order to provide confidence that the price discovery system is reliable
- Be anchored by observable transactions entered into at arm's length between buyers and sellers in the market for the interest the benchmark measures
- Include non-transactional data, such as offers and bids and adjustments based on expert judgment, only to supplement or as an adjunct to transactional data

Lawyers Expect Whistleblower Protections To Be Extended

Fund industry lawyers who closely study the **U.S. Supreme Court** have told *CI* sister publication *Fund Industry Intelligence* that they believe it will extend Sarbanes-Oxley anti-retaliation protections to whistleblowers at adviser firms.

The issue is up for decision in a case the Court accepted recently, *Lawson v. FMR LLC*. *FMR*, parent company of **Fidelity Investments**, is a private company and contends that SOX whistleblower protections do not apply to it. If the Court were to decide in favor of the plaintiff whistleblowers, it could lead to a litany of similar lawsuits—something that would be costly for mutual fund firms.

That the justices should even agree to take the case is a surprise, since the issue has been little aired in lower courts. "I think the Court, even though very conservative, cares about employee rights in the context of terms and conditions of employment," said one fund lawyer.

Whether the fund industry is going to face a whole new world full of whistleblower litigation risk comes down to how the nine people on the Court read a handful of words in SOX: "No company with a class of securities registered under section 12 of the Securities Exchange Act 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee." Previous court interpretations have tended to interpret "company" as a public company; the question is whether that means privately owned fund adviser firms such as FMR, as contractors to mutual funds, are subject to SOX's anti-retaliation ban.

Attorneys disagree over what the words mean and whether people on the other side are inserting words that Congress did not put in the law. **Littler Mendelson** U.S. practice co-chair **Philip Berkowitz** said "to take the word 'employees' and interpret it in the context of contractors like Fidelity, as plaintiffs are doing, is taking language out of the context that Congress intended."

The two plaintiffs, who won in district court and lost on appeal to the First Circuit, are **Jackie Hosang Lawson** and **Jonathan Zang**. A Fidelity spokesman echoed Berkowitz on the notion that the disputed words in the statute applied only to public companies—i.e., the fund—and not to fund contractors such as itself. "We look forward to the Supreme Court's review," the spokesman added.

On the other side, Fidelity is seen as the one adding non-congressional language. "In *Lawson*, the First Circuit ignored the plain meaning of the text, straining to interpret the text to add 'of such public company,'" said **Rosanne Felicello**, principal attorney at **Felicello Law**. "I wouldn't say Fidelity has no chance," assesses one lawyer. "But it has not got a good chance."

Berkowitz, whose sympathies are with the industry, thinks the consequences of the court system giving a green light to whistleblowers in this case are so bad that he conjectures that the reason the Supreme Court jumped in to take the Lawson case now is to "nip in the bud" any trend by lower courts to find for plaintiffs in such cases.

Groups Slam Hedge Funds Over JOBS Act Rule

A new effort is being made by two investor advocacy groups to make it harder for hedge funds to profit from a rule in the works that would let firms pursue general solicitation of investors without registering their securities with the **Securities and Exchange Commission**.

In a May 15 letter to the SEC, **Fund Democracy** and the **Consumer Federation of America** warned about the consequences of ending the ban on general solicitation and allowing hedge fund firms to benefit from such a change. As it stands, the two groups said, the rule proposal "would effectively promote the sale of hedge funds about which the Commission has evidenced strong misgivings, if not outright distrust."

On the subject of whether hedge funds should be able to offer and advertise shares free of SEC oversight, mutual funds have divided counsels. Officially, the **Investment Company Institute** is opposed. If hedge funds could tap the market in this way and mutual funds could not, mutual funds would see their rivals get an advantage. But some fund advisers also own hedge funds. The Fund Democracy and CFA letter quoted an earlier ICI letter that expressed concern about what might be in hedge fund ads aimed at the public. The SEC is on the brink of ending the ban on general solicitations having been required to do so by the 2012 Jumpstart Our Business Startups, or JOBS, Act.

The recent letter from the investor groups described what they said are a variety of faults of hedge funds. After citing data about what the groups called false performance claims by hedge funds, the letter claimed hedge fund reporting practices "do not reflect an occasional exaggeration of performance, but rather an extraordinarily cynical, calculated disregard for truthful performance reporting."

The letter writers concluded: "We strongly encourage the Commission to propose [general solicitation rule amendments] that reflect the costs that documented, widespread misconduct in the hedge fund industry is likely to impose on investors as the result of an unrestricted [general solicitation and advertising rule]."

Mutual Funds Sweat Cross-Border FATCA Agreements


Denise Hintzke

Mutual fund firms preparing to comply with the Foreign Account Tax Compliance Act are growing concerned about the pace at which the U.S. is completing cross-border agreements to implement the rule, according to **Denise Hintzke**, global FATCA tax leader at **Deloitte & Touche**.

The **U.S. Department of the Treasury** has said it is in negotiations with authorities in more than 50 countries with which it hopes to sign intergovernmental agreements (IGAs) to ensure compliance with FATCA. The law aims to prevent tax evasion through a reporting system for foreign entities. Treasury has so far published IGAs with six other jurisdictions: the U.K., Denmark, Ireland, Mexico, Norway and Switzerland (see box).

The negotiation of these arrangements is "the concern I've been hearing most often," Hintzke told *CI*. "There's confusion with the IGAs—how they're going to work, and the fact they're coming out so slowly." Treasury has released two model IGAs that it plans to use, though each agreement completed so far has had small variances from the model, according to Hintzke.

"Where there is some concern—and the place where you could have differences among the countries—is really more on the process side," she said. For instance, while there may be a consistent requirement for funds to report certain information from country to country, each one may require divergent methods for reporting that information. Overseas authorities that complete IGAs are expected to issue guidance clarifying how firms will be expected to comply, Hintzke added.

Before the IGAs go into effect on Jan. 1, 2014, U.S.-based fund complexes need to prepare to register their foreign affiliates, Hintzke said. The **Internal Revenue Service** is in the process of setting up a web portal through which foreign financial institutions (FFIs) will register. The portal should be available on July 15, and firms will have until Oct. 25 to enroll.

The release of the web portal and instructions on how to register are one of a number of items that fund firms are currently awaiting from the IRS, Hintzke said. Firms are also expecting the release of new forms W-8, a release coordinating the FATCA regulations with other sections of the tax code and the FFI agreements themselves, she said. "I think there's going to be a flurry of stuff coming out of the IRS in the next couple of months and then, hopefully, a quick succession of IGAs."

FATCA AGREEMENTS

The Treasury Department has published IGAs with six countries and agreements with several others have been announced. Under so-called Model I agreements, FFIs will report to their home tax authority, while under Model II FFIs will report directly to the U.S.

Completed Model I IGAs: U.K., Denmark, Ireland, Mexico, Norway

Completed Model II IGAs: Switzerland

Announced, but not published, Model I IGAs: British Virgin Islands, Cayman Islands, Singapore, Spain

Announced, but not published, Model II IGAs: Bermuda

The Total Cost of Investment Ownership in Outsourcing: a Q&A with BNY Mellon Industry Leaders

Two leaders in the outsourcing industry—Paul Gately, Head of Global Outsourcing at BNY Mellon, and John Lehner, President and Chief Executive Officer of Eagle Investment Systems, and Head of BNY Mellon Global Outsourcing Services, Asset Servicing Division—provide their views on emerging trends in outsourcing middle- and back-office functions.

BNY MELLON

Q. Let's talk about the decision-making process behind the choice to outsource. What are the drivers behind the decision to move some functions from in-house?

GATELY: In our work, we see three distinct groups with different reasons for outsourcing. The first group is looking for speed to market. The second group desires, above all, to minimize execution risk. The third group is looking to more efficiently utilize their intellectual capital.

For example, managers who are expanding into new asset classes, such as traditional fixed-income managers who want to add alpha, are concerned with how quickly they can be up and operating around the new asset classes.

We have a number of clients who are acquisitive, and who are looking to minimize execution risk. They look to us to help them bring those disparate groups onto the same platform. These situations may involve challenges around asset classes or new geographies, and BNY Mellon delivers the know-how in managing large-scale integration projects.

Fund managers who are focused on achieving the best return on investment are typically evaluating which functions they can place outside the firm. Frequently, they start with the middle-office piece.

Q. What issues arise when fund management companies consider the costs of outsourcing? Are there some considerations that are sometimes overlooked?

GATELY: We find that a significant challenge for managers is measuring the true cost of ownership of the relevant process and its associated technology. Whether a firm is looking at just a snapshot in time, or a continuum, the key issue is whether or not those services are actually sustainable.

As an example, when fund managers examine their costs, they typically consider execution costs, such as trade settlement, and the technology costs for the current year and next. But there are many costs that aren't as tangible and so don't always get quantified. It is a rare investment manager who considers how the cost of data management solutions across the spectrum of research, middle office and sales and marketing. Many managers don't actually take into account that the cost is far greater than the two- or three-person headcount of the middle office.

There's also the requirement for reinvestment in new technology, and in keeping up with changing regulatory and technological standards. These costs can be hard to quantify, but may be substantial.

When you look at the total cost of ownership, the key point is that it is important to consider both the obvious and the not so obvious.

LEHNER: Cost, rather than an organization's ability to cope with change, often becomes a focal point, because the cost of outsourcing is one aspect that companies can grasp.

The true total cost of outsourcing – from people, process, bricks and mortar, the IT and the data – then becomes the battleground, which is unfortunate because the time spent in justifying the cost would be better served in understanding the business or process change. Time is better spent considering what efficiencies and other benefits outsourcing will provide over time, and what options your company may gain that it currently doesn't have.

Q. How are companies blending the boundary between total in-house and complete outsourcing services? Is "co-sourcing" becoming more common?

GATELY: Because of our technological capabilities and the Eagle suite of products, clients can keep their standalone data solutions and add component outsourcing. A lot of the conversations we're having in the U.K. and U.S. are prospects telling us, "My operating system is fine, my trades aren't failing, I'm clearing with the market, but I have an issue with data management." Companies need to consolidate data from different operating systems, for example, to produce substantive client reports.

Clients are focused on their true pain points. Because of our offerings, we are able to have constructive conversations around varying levels of service.

LEHNER: Co-sourcing isn't one-size-fits-all. Some organizations may have already taken steps toward outsourcing, so by default co-sourcing is becoming more common. Companies are often at different points along the continuum.

We are fortunate in that we are able to provide a thorough analytic process because of our broad spectrum of services. We're able to blend and create the right mix of services for clients. Because of the data management issues seen by many companies, co-sourcing is gaining momentum.

Q. From a client's perspective, what are the cost and speed advantages of relying on cloud computing for outsourcing functions, rather than installed technology?

LEHNER: The number one advantage is speed to new functionality, versus the on-premise model.

There are also two other distinct advantages. First is cost, because cloud computing avoids the need for the large fixed costs associated with data centers and employees. Second, because of the nature of how applications and data move in the cloud, access to data is much more open and available than in a traditional in-house model. Linking through to other cloud applications can provide a much more seamless experience than trying to cobble it together in-house.

Cloud computing also allows for economies of scale.

Q. What trends are you seeing in global outsourcing, in terms of adoption of middle-office and back-office services? And how is the desire for transparency affecting the push to outsource?

GATELY: Fund managers are more willing to talk about solutions in middle-office outsourcing, driven by the onus of regulation and as managers seek to keep up with regulatory changes.

Managers, now more than ever, want to focus on the core of their business, which is generating returns for their clients.

Companies planning to expand their businesses want to do so in the shortest time possible. That means managers are refocusing on the most strategic parts of their business. Ten years ago, they might have said the middle-office is off limits, but that's shifted to where fund managers are willing to broaden the discussion.

As for transparency, this is such an important issue. We're investing in toolkits we call "dashboards" which provide a direct line of sight into the quality processing of our operations. In some cases, it provides an hour-by-hour view of what's happening in our organization. Transparency brings a clear economic view around our products to clients, and gives them an effective tool for gaining insights into how much it costs to run new products or individual strategies.

LEHNER: Fund managers have historically considered the performance of a strategy. Now, transparency is also allowing them to consider the cost of running it. Firms are taking a hard look at these issues, and we are here to provide a solution set.

JOHN J. LEHNER

As president and CEO of Eagle Investment Systems, John Lehner shapes the vision and sets the strategy to execute Eagle's mission to help the world grow assets efficiently. He has more than 24 years of experience in the financial services technology industry with a unique background spanning both the buy and sell side. Mr. Lehner joined Eagle in 2000 with the initial goal of establishing Eagle's global sales and operations. Since that time, his responsibilities have expanded and he has played a key role in developing and growing the other areas of the company.

John Lehner

PAUL GATELY

As Head of Outsourcing at BNY Mellon, Paul Gately brings 25 years of experience in global asset management and related businesses. He has a solid understanding of investment services across a broad range of asset classes for retail, institutional, and high net worth investors, and expertise in developing and implementing business strategies in global financial services.

Paul Gately

Ensure Policies Match Exemptive Orders, IAs Warned

Richard Morris

Compliance officers have been put on notice that investment advisory firms must maintain adequate policies to meet conditions attached to exemptive orders on which they rely, after the **Securities and Exchange Commission**'s Division of Investment Management issued guidance reminding them of their obligations in the area.

The Division's guidance is an "indication that this is a current priority of the SEC staff," **Morgan Lewis & Bockius** Partner **Richard Morris** told *CI*. The SEC's Office of Compliance Inspections and Examinations also flagged compliance with exemptive orders as a concern for examiners in 2013, Morris noted. "This is clearly something they have on their minds and which firms and chief compliance officers should be sure to address."

The guidance cautioned firms relying on exemptive orders that they should adopt policies to ensure they comply with the related requirements, or else verify that their existing procedures were sufficient. For instance, if a fund relies on an order conditioned on a board review, the fund may want to create a specific policy to address this, DIM officials wrote. The Division also reminded registrants that the adequacy of any such policy should be checked each year.

Morris recommended that CCOs create checklists containing the key terms and conditions of any exemptive orders they use. These lists should then be checked against the firm's current procedures so the CCO can determine if there are any gaps that need to be addressed, he said, adding that boards should also be alerted to the state of the firm's compliance policies in the area.

Though DIM's guidance only specifically addressed exemptive orders, CCOs should also take the opportunity to review policies in related areas, such as compliance with the conditions of no-action letters and the listing requirements associated with exchange-traded funds, Morris said. In recent years, investment products have grown more complicated and "many of them, such as ETFs, are increasingly reliant on no-action letters and exemptive orders," Morris said, adding that this is one reason the SEC has begun to focus on the issue.

COMPLIANCE TIP

Firms should create a checklist with key terms and conditions of exemptive relief, no-action letters or ETF listing requirements and compare the list against their current procedures.

The agency's Office of Inspector General in 2011 issued a report on firms' compliance with conditions related to exemptive orders and no-action letters. That report cited numerous examples of firms failing to do so and recommended OCIE include compliance with such conditions as risk considerations in planning its exams.

GPs Get CFTC Registration Relief

The general partners of funds that delegate management authority to another commodity pool operator under common ownership won't themselves have to register as CPOs, according to recent no-action letters from the **Commodity Futures Trading Commission**.

The CFTC in May released four similar letters addressing the registration of certain pools that are organized as limited partnerships or limited liability companies. The agency's staff said it would not recommend enforcement action against the general partners or managing members of such pools for failure to register, provided another operator was designated to serve as CPO of the pools and that certain conditions were met. These are:

- The general partners and the designated CPO are under common ownership and control
- Each of the partners has designated all of its investment management authority to the designated CPO
- The partners don't solicit investors for the pool and don't manage property of the pools
- The designated CPO maintains the books and records of each of the general partners at its offices
- None of the partners has employees acting on its behalf and none of the partners engage in other activities subject to the Commodity Exchange Act (CEA)
- None of the partners is subject to statutory disqualification
- The general partners and designated CPO acknowledge in writing an undertaking to be jointly and severally liable for violations of the CEA or CFTC regulations

The CFTC in each of the letters cautioned that the relief provided didn't exempt the general partners from compliance with other requirements of the CEA or CFTC rules. The Commission highlighted, for example, that unregistered partners would still need to adhere to the reporting requirements for traders and CFTC restrictions on advertising.

The ability to delegate CPO registration could ease the compliance burden of general partners. Registered pool operators have recently reported struggles with filings such as the CFTC's CPO-PQR, which must be filed quarterly and is designed to provide the regulator with an overview of the systemic risks in the commodity market (CI, 2/6).

THE BOTTOM LINE:

General partners of commodity pools may delegate another entity under common control to register with the CFTC in their place, provided they adhere to certain conditions.

Policy & Practice

Better Than A Ban?

Social Media: Allowing Use May Ease Compliance Fears

Compliance officers that allow social media use at their firms are breathing easier about meeting their compliance obligations than peers whose firms bar such access, according to a study by technology firm **Smarsh**.

The report found that C/Os at firms allowing employees to use these channels felt more confident of being able to quickly provide regulators with requested messages than those that banned social media felt about being able to prove a prohibition policy is working. It can be particularly difficult to prove a policy of non-usage is being adhered to when it comes to platforms such as **Twitter** or **Facebook** that are often used for personal communications, the report stated. Smarsh polled 284 compliance officers earlier this year.

The results are a little counterintuitive and show C/Os "who thought that prohibiting social media would enable them to sleep better at night actually aren't," Smarsh CEO **Stephen Marsh** told *CI*. "What we've found in a lot of cases is that the compliance department will take a prohibition approach where they don't understand the risks or don't know how to approach them."

There's now less of this denial approach. The focus for most firms now is how to implement operational controls.

—Stephen Marsh, Smarsh

Trying to determine the proper way to police social media use has been one of the most pressing concerns for compliance departments in recent years, Marsh said. Regulators such as the **Securities and Exchange Commission** and **Financial Industry Regulatory Authority** have issued numerous guidelines, indicating that the issue is high on their radar, he added (CI, 3/25).

Marsh compared the industry's response to increasing social media usage to the response to instant messaging systems 10 years ago. At first, firms tended to outlaw the use of IM communications with clients, but employees ended up using them anyway and operating outside of any compliance oversight, he said.

C/Os are increasingly choosing to allow social media use when accompanied by policies and procedures, Marsh said. "There's now less of this denial approach," he said. "The focus for most firms now is how to implement operational controls."

Compliance Clinic

CFTC Swaps Trading Rules: A Guide For CCOs

By Akshay Belani and Joshua Sterling of Bingham McCutchen


Akshay Belani


Joshua Sterling

On May 16, 2013, the **Commodity Futures Trading Commission** approved final rules under the Dodd-Frank Act that—once effective—will set the stage for many classes of swaps to be traded on organized facilities such as swap execution facilities (SEFs).

The new rules mark another milestone in the CFTC's implementation of the Dodd-Frank swaps provisions. Over the past several months, the Commission has issued final regulations requiring the registration of swap dealers and other swaps market participants; the clearing of certain interest rate and credit default swaps; and swap recordkeeping and reporting requirements.

Other final rules, such as those imposing margin requirements on uncleared swaps, remain on the horizon. While much has been done to date, more will be required for firms to bring their trading practices into line with the CFTC's swaps regulations—including as a result of the recently approved rules. Here we discuss some of the key features of those rules that chief compliance officers should keep in mind as they prepare their firms to comply.

The Swaps Block Rule

Among other things, Commodity Exchange Act Section 2(a)(13) requires the CFTC to enhance price discovery by: requiring public availability of swap transaction data; establishing criteria for what constitutes a block trade; protecting the identities of swap market participants; and maintaining the anonymity of their trading positions.

The Swaps Block Rule tries to achieve these aims by setting forth specific swap categories, and the criteria for determining such categories, within the five primary swap asset classes—interest rate, credit, equity, foreign exchange, and other commodities. The categories are based on common risk and liquidity profiles, and the rule provides a methodology for determining the cap sizes and minimum block sizes for each of the swap categories.

The rule provides for cap sizes for publicly reportable swap transactions, which are the maximum notional amount of a trade that will be publicly disseminated by registered swap data repositories, or SDRs. It provides that in the initial period the cap must be equal to the *greater of* the appropriate minimum block size for the swap categories in Appendix F of the rule or those set out in the rule itself. The latter are:

- $250 million for a 0-2 year interest rate swap (smaller for longer tenors)
- $100 million for credit default swaps
- $250 million for equity swaps
- $250 million for foreign exchange swaps
- $25 million for swaps in the other commodity asset class

The CFTC will set post-initial cap sizes using data collected by SDRs within a specific swap category. It will use a rolling three-year window of data with a minimum of one year's worth of data and add one year of data for each calculation until a total of three years of data is accumulated.

The rule provides that block sizes will be implemented in a two-period, phased-in approach. The CFTC will prescribe the appropriate minimum block size during the initial period and then rely on swap data in each asset class to establish the appropriate minimum block sizes for each category in the post-initial period.

During the initial period, the rule provides that minimum block sizes for interest rate and credit swap categories will be determined using a 50% notional amount calculation and, thereafter, using a 67% notional amount calculation. Block trade sizes for forex swaps are based on the block trade sizes for economically related futures contracts set by designated contract markets, or DCMs.

In the post-initial period, therefore, 67% of the sum total of notional amounts in a particular swap category will be reported on a real-time basis. Such swaps will have to be traded on a SEF or DCM. Conversely, swaps equal to or greater than the minimum block size will have delayed public reporting and will not be subject to the trade execution requirement.

An appendix to the rule sets out the initial appropriate minimum block sizes by asset class and swap category that will become effective 60 days after its publication in the Federal Register.

The Made Available To Trade Rule

A swap that is subject to a mandatory clearing determination by the CFTC must be traded on a DCM or SEF, except where no DCM or SEF has made the swap "available to trade." The Made Available to Trade Rule spells out the factors a SEF or DCM must consider in determining whether a particular swap should be made available to trade:

- Whether there are ready and willing buyers and sellers
- The frequency or size of transactions
- The trading volume
- The number and types of market participants
- The bid/ask spread
- The usual number of resting firm or indicative bids and offers

Once a swap is approved or deemed certified as available to trade, all other DCMs and SEFs that list or offer that swap for trading must comply with the trade execution requirements of the applicable SEF or DCM rule. Under the timelines in the SEF Rule, at present it is expected that mandatory SEF trading will begin in late

2013. The swap will be subject to the requirement until all SEFs and DCMs that have listed or offered the swap for trading no longer list or offer that swap.

The SEF Rule

The SEF Rule requires facilities that meet the definition of such an entity in Section 1a(50) of the CEA to register using new Form SEF. A key aspect of this rule is the trading platform or required trading functionality a SEF must offer. It requires a SEF to provide an order book—an electronic trading facility, trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants and transact on those bids and offers.

The final version of the rule, like its proposed draft, distinguishes between so-called “required transactions” and “permitted transactions,” which in turn determines the available execution methods for a trade. For this purpose, a required transaction is any involving a swap subject to the trade execution requirement in CEA Section 2(h)(8). A permitted transaction is any not involving a swap that is subject to the trade execution requirement in CEA Section 2(h)(8).

The rule provides that required transactions that are not block transactions must be executed on a SEF in accordance with one of the following execution methods: an order book; or a request for quote (RFQ) system that operates in conjunction with an order book. In providing either one of these execution methods, a SEF may use “any means of interstate commerce,” provided the chosen execution method satisfies certain additional requirements that will be specified once the rule is published. For permitted transactions, a SEF may offer any method of execution, including voice-based systems.

During the May 16 meeting, the CFTC noted one significant departure from the proposed rule: If a SEF uses an RFQ system, the final rule requires that bids only need to be solicited from two market participants, and this requirement will be increased to three bids in around 15 months. The proposed rule would have required five bids. Critics have labeled this change as a win for swap dealers because it will lower the number of dealers who might be bidding on a particular transaction and arguably make the market less competitive than it would have been.

The rule will become effective 60 days after its publication in the Federal Register, and the CFTC, in its discretion, has set a general compliance date of 120 days following publication. The rule also provides that an applicant for SEF registration that makes a good faith effort to comply with all the Form SEF questions will be given a temporary license before the effective date.

Looking Ahead

Once these rules go into effect, certain trading platforms firms will seek to register as SEFs or as DCMs that execute swaps trades. Once this takes place, firms seeking to transact in swaps that a SEF or DCM makes available to trade will have to conform their trading activities to these requirements and, by extension, requirements of the relevant SEF or DCM.

The expectation is that firms will have at least some time to prepare for this fundamental shift in how they trade these instruments, but it will nonetheless be important for firms to keep abreast of developments in this area so they may be in the best position possible to transition to on-facility trading.

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

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	May 2013	Issued, along with Financial Industry Regulatory Authority, investor alert on pension or settlement income streams.
SEC	May 2013	Responded to letter from College Retirement Equities Fund of TIAA-CREF stating that the Fund intends to omit from its 2013 proxy materials a shareholder proposal submitted by Sandra Fox.
SEC	May 2013	Responded to letter from College Retirement Equities Fund of TIAA-CREF stating that the Fund intends to omit from its 2013 proxy materials a shareholder proposal submitted by Steve Tamari.
SEC	April 2013	Responded to the Committee of Annuity Insurers, the Securities Industry and Financial Markets Association and the American Council of Life Insurers seeking assurance that the staff will not recommend enforcement action if insurance agencies: (i) enter into arrangements with registered broker/dealers for the offer and sale of variable annuity contracts and other life insurance policies or annuity contracts that are also securities; and (ii) make certain transaction-based payments without the insurance agencies registering as B/Ds.
Commodity Futures Trading Commission	May 2013	Division of Market Oversight issued advisory regarding the obligation to report omnibus account information in a timely manner.
CFTC	May 2013	Division of Swap Dealer and Intermediary Oversight responded to four requests for commodity pool operator registration relief.
CFTC	May 2013	Division of Market Oversight issued advisory providing guidance to reporting markets on how to submit block trade volume data.
CFTC	May 2013	Division of Market Oversight issued advisory reminding market participants of certain call cotton reporting requirements and a no-action position allowing for email submission of Form 304 reports.
CFTC	May 2013	Division of Swap Dealer and Intermediary Oversight issued time-limited no-action letter providing relief surrounding certain foreign exchange transactions with a settlement cycle of no more than seven local business days.
CFTC	May 2013	Division of Swap Dealer and Intermediary Oversight issued no-action letter regarding the obligation of swap dealers and major swap participants to provide certain disclosures for certain transactions under Regulation 23.431.
CFTC	April 2013	Division of Swap Dealer and Intermediary Oversight issued no-action letter providing time-limited relief for swap dealers in connection with prime brokerage arrangements.
CFTC	April 2013	To help combat fraud, the CFTC's Office of Consumer Outreach made available new print resources to help consumers learn ways to protect themselves from frequently encountered and potentially devastating commodity futures trading frauds.
CFTC	April 2013	Division of Market Oversight provided no-action relief from swap data reporting requirements to swap counterparties that are not swap dealers or major swap participants.
CFTC	April 2013	Division of Market Oversight and Division of Clearing and Risk issued joint no-action relief for swaps between affiliated counterparties from certain swap reporting requirements.
CFTC	April 2013	Division of Market Oversight issued no-action relief for end-users from certain reporting and recordkeeping requirements of the trade option exemption.
CFTC	Mar. 2013	Division of Swap Dealer and Intermediary Oversight issued time-limited no-action relief to swap dealers and major swap participants regarding certain recordkeeping obligations.
CFTC	Mar. 2013	Division of Swap Dealer and Intermediary Oversight issued no-action relief for certain persons from registration as an introducing broker or commodity trading adviser.
CFTC	Mar. 2013	Division of Swap Dealer and Intermediary Oversight issued no-action relief for certain futures commission merchants concerning annual reports of chief compliance officers.
Financial Industry Regulatory Authority	May 2013	Sent firms targeted exam letter as part of its review of alternative trading systems.
FINRA	May 2013	Issued, along with SEC, investor alert on pension or settlement income streams.
FINRA	May 2013	Provided guidance on communications with the public concerning unlisted real estate investment programs.
FINRA	April 2013	The Securities Industry/Regulatory Council on Continuing Education released its spring 2013 Firm Element Advisory. The Council produces the FEA to identify regulatory and sales practice topics that firms should consider in their Firm Element training plans.
Municipal Securities Rulemaking Board	May 2013	Released municipal market statistics for the first quarter of 2013, including data that provide details about the trading patterns and continuing disclosure documents submitted to the MSRB and other figures.
MSRB	April 2013	Published an introductory guide to the Electronic Municipal Market Access (EMMA) website for state and local government issuers of municipal bonds.
Investment Industry Regulatory Organization of Canada	May 2013	Requested assistance with phase three of its study of high frequency trading activity on Canadian equity marketplaces.
IIROC	April 2013	Proposed guidance on the management of stop loss orders.
Financial Conduct Authority (U.K.)	April 2013	The new FCA Handbook sets out the FCA's policy on the use of its power to direct a qualifying parent undertaking (also known as an unregulated holding company). The powers relate to all FCA-authorized investment firms and recognized U.K. investment exchanges.
FCA	April 2013	Published its approach to investigating and reporting on regulatory failure, as required by the Financial Services Act 2012.
European Securities and Markets Authority	May 2013	Published its final report on guidelines for key concepts of the Alternative Investment Fund Managers Directive.
ESMA	May 2013	Released guidance on the Prospectus Directive.

Rule Docket

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

Regulator	Region	Topic	Details	Upcoming Deadline(s)
Commodity Futures Trading Commission	North America	Persons associated with swap participants	Approved regulations that make clear that each swap dealer (SD), major swap participant (MSP) and other Commission registrant with whom an associated person (AP) is associated is required to supervise the AP and is jointly and severally responsible for the activities of the AP with respect to customers common to it and any other SD, MSP or other Commission registrant.	Becomes effective June 7.
CFTC	North America	Swap participants in clerical or ministerial capacity	Proposed amending its regulations to clarify certain responsibilities of a swap dealer or major swap participant regarding its employees who solicit, accept or effect swaps in a clerical or ministerial capacity.	Comments due June 7.
Nasdaq Stock Market	North America	Initiating trading of halted securities	Filed a proposal with the SEC to amend Rule 4120 to adopt a modification in the process for initiating trading of a security that is the subject of a trading halt or pause on Nasdaq, and to make several additional modifications to Rule 4120 to clarify the conditions under which Nasdaq will conduct a halt cross.	Comments due June 7.
Securities and Exchange Commission	North America	Filing requirements for dually-registered clearing agencies	Affirmed recent amendments to Rule 19b-4 under the Securities Exchange Act of 1934 in connection with filings of proposed rule changes by certain registered clearing agencies and expanded on those amendments in response to comments received. Also made technical modifications to the general instructions to Form 19b-4 that are intended to streamline the rule filing process in areas involving certain activities concerning non-security products that may be subject to duplicative or inconsistent regulation as a result of, in part, certain provisions under Section 763(b) of the Dodd-Frank Act.	Become effective June 10.
CFTC	North America	Clearing exemption for swaps between certain affiliated entities	Approved a rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement under Section 2(h)(1)(A) of the Commodity Exchange Act. Also approved rules that detail specific conditions counterparties must satisfy to elect the proposed inter-affiliate clearing exemption, as well as reporting requirements for affiliated entities that avail themselves of the proposed exemption.	Become effective June 10.
Municipal Securities Rulemaking Board	North America	Sophisticated municipal market professional	Requested comment on proposed rules that would streamline and codify existing guidance regarding the application of rules to transactions with sophisticated municipal market professionals (SMMPs) currently set forth in interpretive guidance to Rule G-17. The proposed changes would create new definitional Rule D-15 and new general Rule G-48 on the regulatory obligations of broker/dealers and municipal securities dealers to SMMPs.	Comments due June 12.
Canadian Securities Administrators	North America	Shareholder rights	Requested comment on proposed National Instrument 62-105 (security holder rights plans), which would establish a comprehensive framework for the treatment of rights plans in Canada that would provide a target company's board and shareholders with greater discretion in the use of such plans.	Comments due June 12.
CSA	North America	Early warning reporting	Requested comment on proposed amendments to the early warning reporting regime in Canada. Proposed amendments include: (i) proposing an early warning reporting threshold of 5%; (ii) requiring disclosure of both increases and decreases in ownership of 2% or more of securities; (iii) proposing that a person include certain equity derivative positions in determining whether the threshold has been reached; and (iv) enhancing the content of the disclosure in the early warning news releases and reports required to be filed.	Comments due June 12.
New York Stock Exchange	North America	Fair representation candidates	Filed a proposal with the SEC to: (i) delete the sections in the listed company manual containing the listing application materials and adopt updated listing application materials that will be posted on the exchange's website; and (ii) adopt as new rules certain provisions currently included in the various forms of agreements that are in the listed company manual, as well as some additional new rules that make explicit existing exchange policies with respect to initial listings.	Comments due June 12.
European Securities and Markets Authority	North America	Prospectus supplements	Published a consultation paper on a proposed regulatory standard concerning situations that require the systematic publication of a supplement to the prospectus that ESMA is obliged to develop in accordance with Article 16(3) of the Prospectus Directive.	Comments due June 14.
Nasdaq	North America	Market maker peg orders	Filed a proposal with the SEC to simplify the calculation of the price adjustment trigger of the market maker peg order (MMPO) under Rule 4751(f)(15). The MMPO is an order type available only to exchange market makers that provides a means by which a market maker may comply with its market making obligations under Rule 4613(a), but also maintain an order price a certain percentage from the national best bid or national best offer.	Comments due June 14.
CSA	North America	Derivatives market	Requested comment on a consultation paper that sets out recommendations on registration and regulation of market participants trading in derivatives. Issues discussed include: (i) activities that would trigger derivatives registration; (ii) categories of derivatives registrants; and (iii) obligations of derivatives registrants.	Comments due June 17.
CSA	North America	Investment funds	Published for comment proposed amendments to National Instrument 81-102 (mutual funds) and Companion Policy 81-102CP as part of its modernization of investment fund product regulation project. The proposal: (i) introduces core operational requirements for publicly offered non-redeemable investment funds, other than scholarship plans; (ii) proposes enhancements to the disclosure requirements relating to securities lending, repurchases and reverse purchases by investment funds; and (iii) seeks feedback on a more comprehensive alternative fund framework.	Comments due June 25.

FINRA Launches *(Continued from page 1)*

into issues such as order types and how firms keep tabs on their ATS. The self-regulatory organization has requested that firms receiving the letter:

- List all orders and their attributes available to the ATS' subscribers
- Describe how order flow from subscribers is identified within the ATS, and explain whether fees are lower for any types of order flow, such as retail orders
- State whether the firm tracks the use of different order types
- State whether the ATS allows subscribers to pick the types of orders with which they will interact within the ATS
- Explain whether the firm allows any affiliate's proprietary traders, including market makers, to enter orders/quotes or other trading interest into the ATS
- Identify all surveillance conducted by the firm in connection with trading on the ATS, including a description of each surveillance pattern
- Describe the conduct the surveillance reviews for or other activity the surveillance is designed to capture
- Describe the resources assigned to any surveillance and supervision of ATS activity, including the number of individuals involved, each individual's function and to whom they report
- Explain the actions that staff at the ATS take in reviewing and following up on conduct identified in the ATS surveillance reports

It is not known which or how many firms received the request. A spokesman for the SRO did not respond to a request for comment.

Even those firms that operate an ATS but did not receive a letter should pay attention to the questions that are asked and conduct an internal review based on the letter, **Bingham McCutchen** Partner **Amy Kroll** told *CI*. She did not necessarily expect the sweep to lead to enforcements. But FINRA will probably circulate best practices it observes and may nudge into line firms examined in the review that the SRO views as deviating from such best practices, she said.

Amy Kroll

FINRA is continuing its close look at ATS at a time when regulators are focused on trading issues that might cause chaos in the market, as seen in the May 2010 flash crash. These fears have been exacerbated over the past year by events such as the software problem that caused **Knight Capital Group** to lose hundreds of millions of dollars and hit almost 150 stocks on the **New York Stock Exchange**.

The SRO in September sent out a similar letter requesting, among other things, a copy of ATS operators' written supervisory procedures and fair access procedures relating to each ATS (CI, 9/18). FINRA was seeking to identify the levels of access available to clients of the ATS and whether any of the firm's ATS send or receive indications of interest, or IOIs.

Kroll described the latest sweep letter as seeking more detailed information than the 2012 request, which she said was focused more on general questions about how firms operate.

In this year's letter outlining regulatory and exam priorities (CI, 1/22), FINRA staffers wrote that the SRO and the **Securities and Exchange Commission** "have identified concerns regarding the manner in which ATS are operating and the adequacy and accuracy of disclosures provided to subscribers about their operations." FINRA is conducting exams of firms that operate an ATS, and the firms' affiliates, to figure out whether they are consistently and accurately representing and disclosing various aspects of their ATS operations to their subscribers, officials said. These include: how they route, represent, interact or otherwise handle subscribers' order flow; how they handle errors; whether and how they use IOIs.

—Ben Maiden

FINRA To Issue *(Continued from page 1)*

training was a key element in implementing an effective conflicts management framework, along with having policies, procedures and controls for reviewing new products as "an important check point for identifying potentially problematic products, including from a conflicts of interest standpoint," he said.

FINRA's review is particularly focused on controls firms have developed around the sale of structured products both to their own private wealth divisions and to other firms, Ketchum told attendees. The SRO is also looking closely at B/Ds' controls around compensation—both in terms of efforts to design their own "product agnostic commission grids" and in terms of incentives for third parties, he said.

In addition, the conflicts review is focused on the quality of disclosure to clients, Ketchum said. "It is important to note that structured products raise particular challenges regarding effective training of your financial advisers and effective disclosure to your customers," he said. "How do we change the dynamic so investors truly understand what they're buying and, likewise, that financial advisers understand what they are selling?"

Ketchum noted that many firms' websites include plenty of plain English content in terms of marketing, but not in terms of legal and risk disclosures. "I know that litigation concerns have a role in shaping the legislative manner in which risks are disclosed today. But, frankly, disclosure that investors and your financial advisers can't absorb, in the end creates more risks for firms," he said, urging the industry to use behavioral psychology in making risk disclosure as clear as marketing material.

"We need to move beyond a culture of compliance to ensure that investors have a better understanding of risk and what's being sold," Ketchum said, pointing to fixed income and funds that invest in leveraged loans as two examples of areas where firms need to increase communications with clients. In terms

THUMBS UP: KETCHUM SEES COMPLIANCE PROGRESS

While acknowledging there is much work to be done. Ketchum said there have been "tremendous improvements in how most firms handle their compliance responsibilities over the past 10 years." He said these have included:

- Improved coordination among firms' compliance, risk management and legal teams
- In complex firms, better controls within the B/D and better communication among affiliates
- Firms say they have improved due diligence process for new products
- Firms say they have improved technology used in automated surveillance of customer activity
- More firms are taking proactive steps to improve data security

of fixed income instruments, FINRA is concerned that in a low interest rate environment investors are seeking returns by buying high-yield products—and thereby taking on risks they cannot understand or afford.

Funds that invest in floating-rate loans may be marketed as being less vulnerable to interest rate fluctuations and offer inflation protection, but the underlying loans in the fund are open to major credit, valuation and liquidity risks that may not be obvious to investors, Ketchum said. "If you are going to make these investments available to retail investors, you should think carefully of how to explain the possible negative scenarios that can impact this investment to your clients and your financial advisers."

Robert Frenchman, partner at **Bracewell & Giuliani**, noted FINRA's apparent focus on sales practices, particularly in terms of structured products. But, he told *CI*, "[As] a CCO, this is an issue you want to be looking at more broadly than sales practices." The problem, he said, is that firms tend to be better at spotting internal technical violations of rules than finding conflicts of interest, as these get to the core of the business. It may be easier for an independent auditor or outside counsel to see conflicts, he added.

—Ben Maiden

They Said It

"I know that litigation concerns have a role in shaping the legislative manner in which risks are disclosed today. But, frankly, disclosure that investors and your financial advisers can't absorb, in the end creates more risks for firms."— **Richard Ketchum**, chairman and CEO of the **Financial Industry Regulatory Authority**, on using plain English in communications with investors (see story, page 1).

BAR STOOL

No Facebook Post Left Behind?

Ah, social media. The bane of so many a chief compliance officer's life. Regulators have tried to help, with both the **Securities and Exchange Commission** and the **Financial Industry Regulatory Authority** having issued guidance. But the fact remains that financial industry professionals want to use these new platforms to deal with clients, and that doing so raises a forest of potential liabilities.

So it's easy to have sympathy for CCOs when advisers start demanding access to **Twitter** or **LinkedIn**…except that many firms still aren't doing enough to protect themselves, a recent survey suggests. The poll, by technology firm **Smarsh**, found that although roughly four in five firms have policies governing usage of LinkedIn, Twitter and **Facebook**, many do not have an archiving/supervision system in place to support those policies (see graph, page 1). True, the gap between those with policies and those who can patrol them has shrunk slightly. But just 38% of firms with Twitter policies have an archiving/supervision system. Those with Facebook (41%) and LinkedIn (53%) policies don't do much better.

"This indicates that firms recognize the need for policies and have taken the step to put them in place, but oversight…hasn't kept up," the report's authors wrote. Of course, it may well not be the CCO who is to blame. It can be tough to get the resources for such a project. But it's worth trying. (For more on the survey see story, page 13.)

One Year Ago In Compliance Reporter

The **Commodity Futures Trading Commission** was preparing to release for comment guidance regarding the cross-border application of swaps market rules it is implementing under Title VII of the Dodd-Frank Act. The proposal would include interpretive guidance on how these reforms apply to cross-border swap activities. [The **Securities and Exchange Commission** last month proposed its own rules and interpretive guidance for cross-border security-based swap transactions (see story, page 3).]

Five Years Ago

Hedge fund firms were preparing to step up their efforts to protect whistleblowers, even though investment advisers were not subject to related Sarbanes-Oxley requirements. [Under the Dodd-Frank Act, the **Securities and Exchange Commission** can now pay financial awards to a broader array of whistleblowers. Earlier this year, the SEC's Office of Inspector General gave the agency's whistleblower program a generally clean bill of health (CI, 1/29).]