INVESTMENT MANAGEMENT LEGAL+REGULATORY UPDATE

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MORRISON FOERSTER

REGULATION

DOL Issues Additional Guidance on Fiduciary Rule

On January 13, 2017, the U.S. Department of Labor ("DOL") issued a second set of guidance on its new fiduciary rules, which are scheduled to become effective on April 10, 2017. The guidance was issued in the form of FAQs and is the second round of guidance to be published by the DOL prior to the effective dates of the new rules. Earlier in January, the DOL issued FAQs directed at consumers instead of practitioners that contain general information about the new fiduciary rules.

For additional insights, see our Client Alert and blog post here and here.

Mutual Funds Come Clean: Brokers Can Set Fund Share Sales Charges

The staff of the SEC's Division of Investment Management effectively allowed brokers to determine the commissions they will charge their customers who buy "Clean Shares" of mutual funds.

In a "no-action" letter dated January 11, 2017, the staff said that it concurs with the view that the restrictions of Section 22(d) of the Investment Company Act of 1940 ("1940 Act") would not apply when a broker, acting as agent for a customer, charges its customers commissions for effecting transactions of a mutual fund without any front-end, back-end or other asset-based sales charge (so-called "Clean Shares").

Section 22(d) generally prohibits brokers from selling mutual fund shares at a price other than "a public offering price as stated in the prospectus." The original purpose of the restriction was to prevent price discrimination against different types of shareholders. Until now, this provision was interpreted to mean that brokers could not add a sales charge to a no-load fund. That is, brokers could only earn a commission paid from an offering price that included a sales charge (or other sales charge structured as a back-end or asset-based sales charge).

The staff's new interpretation is based on a strict reading of Section 22(d), which does not on its face apply to a broker-dealer acting as a broker. The provision would apply, however, to a broker-dealer acting as a dealer, such as the fund's principal underwriter.

To sell Clean Shares, a broker must satisfy the following conditions:

- It will represent in its selling agreement with the fund's underwriter that it is acting solely on an agency basis for the sale of Clean Shares;
- The Clean Shares will not include any form of distribution-related payment to the broker;
- The fund's prospectus will disclose that an investor buying or selling Clean Shares may be required to pay a commission to a broker, and, if applicable, that other shares classes have different fees and expenses;
- The broker must determine the nature, amount and timing of the commissions in a manner consistent with the law, including FINRA and DOL rules; and
- Purchases and redemptions of Clean Shares will be made at net asset value established by the fund.

For additional insights, see our Client Alert here.

OCIE 2017 Exam Priorities: Focus on Retail, Elderly and Retirement Investors; Market Risks

The SEC's National Examination Program ("NEA") of the Office of Compliance Inspections and Examinations ("OCIE") announced that its examination priorities in 2017 will focus on three general areas: retail investors, risks specific to elderly investors and retirement investing, and assessing market-wide risks.

Protecting Retail Investors

Robo-advisers. For the first time, OCIE will focus on so-called "robo-advisers" that provide automated online investment advice. In particular, OCIE will examine compliance practices for overseeing the advisers' algorithms that generate investment recommendations.

Wrap fee programs. OCIE will expand its focus on wrap fee programs, which charge investors a bundled fee for advisory and brokerage services. Examinations will focus on investor suitability, disclosures, and conflicts of interest. Some wrap fee programs in the past have been scrutinized for "reverse churning," a practice that minimizes trades in a client's account to reduce out-of-pocket expenses to an adviser charging a fixed fee.

Exchange-traded funds. OCIE will focus on how ETFs comply with their exemptive orders. In addition, OCIE will review sales practices and suitability of broker-dealer ETF recommendations.

Never-before examined investment advisers. OCIE will continue its program of focusing on newly formed advisers and those that have never been examined.

Recidivism. OCIE will step up its attempts to identify repeat offenders at investment advisers and broker-dealers.

Multi-branch advisers. OCIE will continue to focus on advisers that provide advisory services from multiple locations. OCIE published compliance guidelines for multi-branch advisers in December 2016, which provide a clue to what multi-branch advisers can expect from examiners.

Senior Investors and Retirement Investments

OCIE will continue to emphasize examinations of advisers and broker-dealers that recommend sales of variable insurance products and target date funds for retirement accounts. OCIE also will look at how pension plans of government entities manage conflicts of interest in managing those investments and focus on "interactions" with senior investors with a view to identify "financial exploitation."

Market-wide Risks

Money market funds. OCIE will focus on how money market funds comply with recent changes to the rules that govern them.

Payment for order flow. A perennial favorite of examiners is back: OCIE will focus on ensuring that broker-dealers comply with their duty to seek best execution when routing customer orders for execution.

Clearing agencies. Using a risk-based approach, OCIE will continue to focus on "systemically important" clearing agencies, pursuant to authority provided by Dodd-Frank.

FINRA. OCIE will enhance its oversight of FINRA, including inspections of FINRA's operations and regulatory programs.

Regulatory systems compliance and integrity ("SCI"). OCIE will step up examinations of SCI entities to ensure the integrity and efficiency of their systems, including enterprise risk management.

Cybersecurity. Cybersecurity continues to be a top priority of OCIE examiners.

National securities exchanges. OCIE will continue risk-based examinations of national securities exchanges, focusing on operational and procedural controls.

Anti-money laundering ("AML"). OCIE will look at broker-dealer AML programs to ensure they are tailored to address specific risks and how they monitor for suspicious activity.

Other Initiatives

OCIE will also allocate resources to examinations of municipal advisors, transfer agents and private fund advisers, with particular focus on conflicts of interest.

Our Take

OCIE will continue to focus on previously stated priorities. It has added some new ones, however, and there are subtle shifts of how OCIE presents its priorities. Notwithstanding pending changes in the SEC and its staff, we expect OCIE examinations to continue at the same pace and with the same degree of focus, at least in the foreseeable future.

FINRA Issues 2017 Examination Priorities Letter

Consistent with prior practice, with the arrival of the new year, FINRA has published its key examination priorities.

As in prior years, the letter covers a broad array of topics. This year's topics include:

- Hiring and monitoring the activities of "high-risk and recidivist brokers";
- Sales practices, including protecting seniors, evaluating firm practices relating to reasonable-basis and customer-specific suitability, and monitoring product concentration;
- Excessive and short-term trading of long-term products, such as mutual funds and closed-end funds;
- Operational risks, including cybersecurity, supervisory controls testing, consumer protection and segregation of client assets, and anti-money laundering and suspicious activity monitoring; and
- Market integrity issues, including best execution and trading examinations.

Of course, each member firm should read the letter carefully and assess the identified priorities in the context of its own business and business plans. Below, we discuss a number of areas that may be of particular interest to a number of market participants and clients, including some specific items that FINRA raises in its letter.

New: Off-Site Reviews

In the letter, FINRA indicates that in 2017, it will begin conducting electronic off-site reviews that will supplement its traditional on-site examinations. The off-site reviews are designed to enable FINRA to review selected areas discussed in the letter, without a visit. These off-site reviews will be conducted only as to a limited number of broker-dealers that are not scheduled for a 2017 cycle exam. We would expect that this process will help leverage FINRA's ability to understand market practices as to key issues.

High-Risk and Recidivist Brokers

Consistent with its recent inquiries regarding firm culture and hiring practices, FINRA will focus on the hiring and monitoring of "high-risk and recidivist brokers." For example, FINRA will explore the implementation of supervisory and compliance controls for such individuals. The letter indicates that FINRA will, among other things, review whether a firm or a third-party agent reviews available public records to verify the accuracy of the relevant individuals' form filings.

Sales Practices

- *Senior Investors*: FINRA continues to take a strong interest in protecting senior investors. FINRA's concern arises from its ongoing observations that brokers have continued to recommend unsuitable products to senior investors, including complex or novel exchange-traded products, structured products, leveraged and inverse exchange-traded funds, non-traded REITs and unlisted BDCs. FINRA reminded firms of a variety of tools that can be used to help protect elderly clients from exploitation under questionable circumstances, including contacting the investor about orders placed through an on-line brokerage account or about instructions to transfer funds to persons who may be linked to an issuer.
- *Suitability*: FINRA remains concerned that brokers are recommending unsuitable complex products to customers. Accordingly, examinations will assess how firms discharge their reasonable basis and customer specific suitability obligations.

FINRA will also focus on the controls that brokers use to monitor recommendations that could result in excess concentration in client accounts.

Social Media

FINRA will review firms' compliance with their supervisory and record-retention obligations with respect to social media and other electronic communications.

Excessive and Short-term Trading of Long-Term Products

FINRA will evaluate firms' ability to monitor the short-term trading of long-term products. FINRA's concern is that registered representatives may recommend that clients trade long-term products, including mutual funds, closed-end funds and UITs, on a short-term basis, resulting in increased costs to investors or other adverse results. This review follows on the heels of FINRA's September 2016 targeted exam relating to rollovers. FINRA believes that some registered representatives are using early UIT rollovers to increase their sales credits to the detriment of clients.

In addition, FINRA urges firms to evaluate whether their supervisory systems can detect activity intended to evade automated surveillance for excessive switching activity. For example, FINRA believes that some registered representatives may be switching customers across products to evade surveillance that focuses on switching within the same product class.

Regulation SHO

FINRA indicates that it will continue to assess firms' compliance with SEC Regulation SHO. The letter notes:

"In light of recent SEC enforcement actions, FINRA will focus on the locate process to ensure firms have reasonable grounds to believe securities are available for borrowing prior to accepting a short sale. FINRA will assess firms' preparation and use of the easy-to-borrow list as well as evaluate the adequacy of firms' automated locate models. FINRA has observed fails-to-deliver on settlement date, when locates are granted without the requisite reasonable grounds to believe that the security could be borrowed. Firms should continue to monitor their close-out processes and ensure that they appropriately close out fails-to-deliver by the designated close-out date pursuant to Rule 204 of Regulation SHO."

Our Take

As is usually the case, FINRA's letter is useful because it highlights what broker-dealers should expect from FINRA this year, and it offers practical examples. This year's letter is noteworthy for its focus on objective criteria and factual processes, which should help broker-dealers prepare an appropriate course of action.

A Case of Appendicitis: SEC Staff Guidance on Sales Load Variation Sends Funds Scrambling

A Guidance Update published in December 2016 by the SEC's Division of Investment Management has sent funds scrambling to beef up prospectus disclosures to accommodate changes to fees charged by financial intermediaries before the DOL "conflicts of interest" rule kicks in on April 10, 2017.

The conflicts of interest rule, which the DOL finalized on April 8, 2016, generally subjects financial intermediaries (e.g., broker-dealers) that sell certain retirement products, including IRAs funded by mutual fund shares, to a fiduciary standard rather than the "suitability" standard that now applies only to non-retirement accounts. To comply with the rule, broker-dealers must effectively level the compensation that funds pay them for the sale of fund shares. The financial intermediaries, in turn, have pressured funds to streamline the sales load structures of fund share classes. For example, financial intermediaries may require simplified costs and tailored sales charge waivers relating to specific classes of fund shares. In an effort to eliminate conflicts of interest, some intermediaries may decide to charge the same fee for all mutual funds, as opposed to different charges.

Funds seeking to accommodate the myriad financial intermediaries that sell their shares, however, may face the daunting task of revising their prospectus disclosure. SEC rules require funds to disclose specific arrangements that result in, among other things, variations or eliminations of sales loads that apply to each individual class of shares. Investors who purchase shares through an intermediary would be a "class" under the rule and, therefore, the disclosure should specifically identify each intermediary whose investors received a sales load variation. This requirement can lead to clunky and confusing disclosures when many intermediaries have special arrangements.

The Division's Guidance Update offers substantive and procedural guidance related to the disclosure challenges that funds face as they attempt to keep up with the barrage of new requirements from financial intermediaries, who, in some cases, are requesting funds to include specific prospectus disclosures.

The challenge. Many funds had planned to complete their annual update by filing a post-effective amendment that goes effective immediately upon filing. (To accomplish this, funds must confirm that the filing contains no material changes other than updated financial information and other non-material information.) The Division's guidance, however, requires that funds give the staff 60 days to review disclosure amendments that add information about sales load variations. This requirement has sent funds scrambling to figure out how to revise disclosures that may cut across many funds with prospectuses containing multiple dates and fiscal years in time to meet the effective date of the DOL's conflicts of interest rule in April.

The appendix. The staff recognized that adding lengthy disclosures about sales load variations particular to multiple financial intermediaries may make it difficult for investors to slog through bulked-up prospectuses. The guidance lets funds relate this disclosure to an "appendix" that may be a separate document, provided that the funds comply with certain conditions. To use an appendix, among other things:

- the prospectus must prominently disclose that different intermediaries may impose different sales loads, and that these variations are described in the appendix; and
- the cross-reference in the narrative explanation to the fee table must cross-refer to the appendix, and the appendix must specifically identify the name of the intermediary and provide enough information to allow investors that buy shares through the intermediary to determine which of the scheduled fee variations apply to the investment; this may depend on the type of account held at the intermediary (e.g., retirement versus non-retirement account).

Moreover, funds must include a legend on the front cover page of the appendix explaining that the information disclosed in the appendix is part of, and incorporated in, the prospectus; and a statement on the back cover page of the prospectus stating that information about sales charge variations is included in the appendix, which is incorporated in the prospectus. Funds must deliver the appendix along with the prospectus to investors and must generally post the appendix on the fund's website.

New share classes. The staff said that when a fund files an amendment to register shares of a new class, it will focus on fund fees, performance and distribution arrangements.

Procedural issues. The staff encouraged funds that file an amendment to add disclosures about sales charge variations or to create a new share class that varies from other classes only in the distribution arrangements, to request "selective review." That is, in the cover letter to the filing, the fund would highlight the disclosures that vary from disclosures in existing prospectuses and ask the staff to focus principally on those changes.

When a fund complex anticipates making substantially identical disclosure changes to multiple funds complex-wide, the staff suggested that funds request permission to make a "template filing." That is, if the staff reviews and comments on new disclosures for one fund (made in a 60-day filing), funds can ask the staff to let the other funds in the complex skip the 60-day requirement and file amendments with the same new disclosures to go effective immediately. This would prevent the need to file multiple amendments each having a 60-day review period.

Our Take

Funds are likely to incur substantial legal, administrative, printing and mailing costs to help financial intermediaries comply with the DOL's new conflicts of interest rules. These costs may be further increased when funds must change their production schedules to account for the required 60-day review of post-effective amendments containing new disclosures about sales load variations. While the future of the conflicts of interest rule may be uncertain, one thing is for sure: funds will incur additional costs as intermediaries move to comply with the new rules, and they may again if the new rules are changed, delayed or repealed in the coming months.

Unfinished Business: Former SEC Chair Reveals New Rules Ready to Go

In a letter dated December 12, 2016, to the Chair of the Senate Committee on Banking Housing and Urban Affairs, former SEC Chair Mary Jo White took issue with a request to defer consideration of new rulemaking during the post-election period. Citing the SEC's Canons of Ethics, the former Chair reminded the Senate that it must act independently in performing its duties "without fear or favor."

The letter is noteworthy because it reveals new rules that "are ready for Commission consideration," including, among others, rules concerning:

- investment company use of derivatives (Rule 18f-4)
- web transmission of shareholder reports (Rule 30e-3)
- capital, margin and segregation requirements for security-based swap dealers and major security-based swap participants
- recordkeeping rules and notification requirements for security-based swap dealers and major security-based swap participants
- orderly liquidation of certain broker-dealers
- proposed disclosure rules for bank holding companies

None of these initiatives come as a surprise because former Chair White has listed them as part of a long-standing agenda. The letter, however, serves as a useful reminder that the SEC is duty-bound to act independently and resist political pressure from any source. Former Chair White noted that, historically, the SEC has enacted important rules during comparable post-election periods. The SEC, she said, should not "deviate from its historical practice of independently carrying out its duties."

Big Regulatory Changes in Store for Funds and Advisers? No One Knows for Certain, but Here's Our Best Guess

While no one knows for sure what the future holds for investment management regulation, the tea leaves indicate that we may expect a slowdown on new regulations, some pullback on parts of Dodd-Frank, and an abundance of uncertainty.

We provide some observations for investment companies, their independent directors, investment advisers, broker-dealers and other service providers that want a peek at how we see the future unfolding in our Client Alert here.

FINRA Proposes Rules to Protect Seniors from Financial Exploitation

In October 2016, FINRA filed with the SEC proposed rules designed to help brokers protect seniors and other vulnerable adults from financial exploitation. The proposal would amend existing customer account information rules to require brokers to attempt to obtain the name and contact information for a "trusted contact person" upon opening an account. Brokers would have the benefit of a "safe harbor" enabling them to place a temporary hold on a disbursement of funds or securities, and to notify a customer's trusted contact, if they have a reasonable belief that financial exploitation is occurring.

The proposal follows FINRA's September 2015 Notice to Members 15-37 ("NTM 15-37") (see our related blog post). The proposed rules revise the prior proposal set forth in NTM 15-37 in some respects, based on feedback from public comments.

Under the proposed rules, a broker-dealer could rely on the safe harbor when the firm has a reasonable belief that financial exploitation is occurring in accounts owned by investors aged 65 or older, or by investors 18 and older, with mental or physical impairments that render them unable to protect their own interests.

For additional insights, see our blog post here.

SEC Approves New Liquidity Risk Management Rules; Swing Pricing Rules

On October 13, 2016, the SEC unanimously approved "transformational" new rules requiring liquidity risk management programs. The SEC also approved a swing pricing rule by a vote of 2-1, with Commissioner Piwowar voting against it. The SEC made several significant changes to the proposed rules to address concerns that the rules would improperly hamstring funds in meeting their objectives.

For additional information, see our blog post here.

SEC Adopts New Reporting Rules for Mutual Funds

An October 13, 2016 split SEC approved new rules addressing mutual fund disclosures and liquidity. Chair White and Commissioner Stein voted yes; Commissioner Piwowar voted no.

The highlights of the new reporting modernization rules are available here.

House Bill Would Ease Regulatory Restrictions to Private Fund Advisers

On September 9, 2016, the U.S. House of Representatives approved a bill that would amend the Investment Advisers Act of 1940 ("Advisers Act") to modernize certain disclosure requirements and lessen regulatory burdens on private fund advisers. The proposed amendments would not apply to advisory services provided to registered investment companies.

H.R. 5424, the Investment Advisers Modernization Act of 2016, would, among other things, direct the SEC to amend certain specified regulations related to advertising, custody, recordkeeping, brochure delivery and assignment of advisory contracts.

For additional information, see our blog post here.

Capital Acquisition Brokers: New Category of Broker-Dealers Provides Limited Relief for Some Investment Banking Boutiques

The SEC recently approved a set of FINRA rules that creates a new category of broker-dealers known as Capital Acquisition Brokers or CABs. The rules were originally proposed in 2014 and will go into effect on the date set forth in FINRA's regulatory notice regarding approval of the rules. The CAB rules are intended to provide regulatory relief for broker-dealers that limit their activities to investment banking. However, the relief provided is limited, and the constraints on what business may be conducted by a CAB may diminish the interest of many broker-dealers in using this new category.

For additional insights, see our Client Alert here.

OCIE Announces Adviser Supervision Practices Initiative

On September 12, 2016, OCIE published a National Exam Program Risk Alert announcing an initiative to examine the supervision practices of registered investment advisers ("RIAs") that employ individuals with a history of disciplinary events in the financial services sector (the "Supervision Initiative"). OCIE intends to assess RIAs' business and compliance practices, with a particular focus on those practices related to their supervision of "higher-risk individuals." According to OCIE, persons with regulatory disciplinary histories may pose increased risks to advisory clients.

The Supervision Initiative will assess whether RIAs have implemented policies and procedures specific to the risks presented by employees with disciplinary histories. Examinations will focus on those advisers' compliance cultures and "tone at the top."

The Supervision Initiative examinations will include the following key areas:

- Compliance Program. Examiners will review an RIA's practices surrounding its hiring processes, ongoing reporting obligations, employee oversight practices and complaint handling processes under Rule 206(4)-7 under the Advisers Act, including whether the RIA fosters a robust compliance culture.
- Disclosures. Examiners will likely review the RIA's practices regarding its disclosures of regulatory, disciplinary or other actions, with a focus on assessing the accuracy, adequacy, and effectiveness of such disclosures, including those on the RIA's Form ADV.
- Conflicts of Interest. Examiners will assess the RIA's or supervised persons' conflicts of interest, with a particular focus on conflicts that may exist with respect to financial arrangements (e.g., unique products, services or discounts) initiated by supervised persons with disciplinary histories.
- Marketing. Examiners will review the RIA's advertisements, including pitchbooks, website postings and public statements, to identify any conflicts of interest or risks associated with supervised persons who have a history of disciplinary events.

Our Take

The Supervision Initiative should come as no surprise to RIAs, since OCIE alluded to the initiative and its use of data analytics in its Examination Priorities for 2016, which we wrote about here. The Supervision Initiative also mirrors, to some extent, FINRA's interest in "compliance culture," which similarly emphasized the issues surrounding the hiring of individuals with disciplinary records. While many RIAs are already sensitive to hiring individuals with disciplinary histories, firms should review their hiring records to determine if they are likely to draw OCIE's attention. Firms should also review their compliance policies and procedures to ensure that they are robust, identify high-risk individuals and mitigate the risks that these individuals may pose.

The SEC Adopts Amendments to Form ADV and Recordkeeping Rule: Advisers Now Required to Disclose Information About Separately Managed Accounts

The SEC recently amended Form ADV to require investment advisers to disclose more information about their separately managed account business, aggregate data related to the use of borrowings and derivatives, and disclose information about other aspects of their advisory business, including branch office operations and the use of social media. The amendments also streamline registration and reporting for "umbrella registrations" made by groups of private fund advisers operating a single advisory business.

For additional insights, see our Client Alert here.

ENFORCEMENT + LITIGATION

Former New York Pension Official and Two-Broker-Dealers Charged in Pay-to-Play Scheme

On December 21, 2016, the SEC charged the former Director of Fixed Income for the New York State Common Retirement Fund (the "NYSCRF") with allegedly steering billions of dollars of NYSCRF assets to two broker-dealers in exchange for hotel room stays, restaurant outings, jewelry, concert tickets and vacations. In total, according to the SEC, the former Director allegedly received $180,000 in undisclosed gifts. The SEC alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act. While differing from one another in certain respects, both Sections encompass anti-fraud provisions. The two broker-dealers are also charged in the same action.

According to the complaint, the former Director had investment responsibility for approximately $50 billion of NYSCRF assets. The NYSCRF is the third-largest public pension fund in the United States and, as of March 31, 2016, had approximately $178 billion in assets held in trust for pension benefits.

At the time the former Director arrived at the NYSCRF, according to the complaint, neither broker-dealer was executing trades on behalf of the NYSCRF. However, the SEC alleged that, within three months, trade-execution business with both broker-dealers increased significantly. The SEC alleged that by the end of the 2016 fiscal year, $2.38 billion and $1 billion in fixed-income trades were executed by the two broker-dealers, respectively. The increase in business (and the associated brokerage commissions), according to the SEC, coincided with the lavish gifts allegedly given to the former Director.

For background on the application of pay-to-play to investment advisers, see here.

U.S. District Court: Fund Trustees Cannot Rely on Attorney-Client Privilege in Section 36(b) Case

A federal district court has ordered mutual fund trustees to produce privileged documents to a plaintiff who sued an investment adviser accused of charging excessive investment advisory fees. The November 21, 2016 order may pave the way for plaintiffs in "excessive fee" cases to brush aside the attorney-client privilege and learn what independent trustees discussed with their legal counsel in executive session meetings.

For additional insights, see our Client Alert here.

FINRA Fine Addresses Broker Compensation and Conflicts of Interest

A recent enforcement action by FINRA underscores the regulator's continuing concern regarding how financial advisers are paid to sell investment products. In a case announced on November 28, 2016, a member firm settled charges brought by FINRA and agreed to pay a fine of $1,750,000. The FINRA case includes a wide range of allegations involving failure to supervise, train and monitor the sales process for variable annuities. At the heart of the case, however, are concerns about how the firm compensated its sales force. These types of concerns are likely to be of interest to a wide range of broker-dealers, no matter what types of financial products they offer to investors.

FINRA found that the firm's financial advisers were incentivized to roll over retirement funds into various proprietary products, including accounts that would pay ongoing fees to the firm. If a financial adviser was also registered as an investment adviser representative, he or she could also receive a share of the ongoing management fees paid by the account. By contrast, the financial advisers would not be compensated if they recommended that the customers invest in non-proprietary products. According to FINRA, the implementation of sales incentives favoring proprietary products was quickly followed by a marked increase in the sale of certain proprietary products, in some cases generating more than 600% growth.

Well after implementing the new sales incentives, the firm required customers to sign a disclosure document that provided general disclosures about the compensation payable to its financial advisers, including the fact that compensation would be "more favorable" for the sale of proprietary products. The specific compensation terms were not disclosed.

The case is notable because of the significant fine levied in the absence of any charges that the firm or its financial advisers committed fraud or sold unsuitable products in substantial amounts. FINRA stated that the firm's "compensation policy created a conflict of interest between registered representatives and customers…" FINRA also found that the firm failed to identify and reasonably address this conflict of interest, which involved an inherent risk that financial advisers would act imprudently, rather than in the interests of their customers. The stark incentives to sell proprietary products, coupled with the extraordinary growth of these sales after adoption of the incentives, were no doubt seen by FINRA as exactly the kind of conflicted conduct that needed to be deterred, even where there was no demonstrable fraud or violations of the suitability requirements.

The case is consistent with FINRA's recent focus on conflicts of interest as demonstrated by its sweep examination in 2015 and its 2013 report relating to conflicts of interest. Moreover, the issues raised in the case resonate with the DOL's new fiduciary standards, which would expressly require brokers dealing with retail retirement investors to avoid compensation systems that misalign the interests of financial advisers and their customers.

The lesson for broker-dealers and other investment firms: think carefully about the structure of your compensation policy. Where sales incentives appear to create a potential for conflicts of interest, take actions to mitigate and disclose the conflict. Continually monitor financial adviser behavior and respond quickly to indications that a particular compensation policy may be improperly affecting the advice that financial advisers provide to clients.

Inside FINRA's "Cross-Selling Sweep"

In response to recent highly-publicized scrutiny of bank cross-selling practices, FINRA announced in October 2016 that it is conducting a sweep of broker-dealers to determine the extent to which they are:

- promoting bank products of affiliated or parent companies to broker-dealer retail customers; and
- adding different features to broker-dealer retail customer accounts such as securities-based loans or opening additional broker-dealer accounts.

The sweep letter has a very broad scope and requests a wide range of information about broker-dealer policies, procedures and practices relating to cross-selling, including the potential compensation to employees for such cross-selling. In light of recent events, the sweep letter conveys a particular interest in determining whether any of these products were sold without customer authorization.

The inquiry also requests copies of marketing materials used by broker-dealers to advertise bank products that are subject to the sweep. Of course, for some market participants with a robust array of financial products, the amount of documents required to be delivered under the sweep could be somewhat voluminous.

The inquiry mentions "bank products" without defining that term. On its face, the term would appear to cover structured products and instruments such as CDs and structured bank notes, which are issued by a bank. However, the term may not necessarily cover structured notes issued by a bank holding company. That being said, because the letter also refers to broker-dealer parent companies, the request arguably relates to structured notes and other instruments issued by parent corporations, particularly in light of the potential conflicts of interest that can arise from cross-selling programs.

To a significant extent, this new sweep letter requests information that may have been provided to FINRA through prior sweeps. For example, February 2016's sweep relating to firm culture requested information as to a variety of compensation practices that could impact how sale determinations are made. Similarly, FINRA's August 2015 sweep relating to compensation and conflicts of interest explored the manner in which some compensation programs may inappropriately incentivize financial advisors to sell products that may not be appropriate for customers.

The recent publicity concerning cross-selling programs likely reflects a concern on FINRA's part that its prior guidance may not have been properly followed, and its concerns not properly addressed, with respect to these types of programs. The results of the sweep, and any follow-up actions by FINRA, may reveal the extent to which FINRA is satisfied as to the efforts that broker-dealers are making regarding the conflicts of interest that may arise in these types of incentive programs.

SEC FY 2016: A Record Year for Enforcement Cases Against Funds and Advisers

On October 11, 2016, the SEC announced that it prosecuted a record number of enforcement cases against investment advisers and investment companies in the fiscal year ended September 30, 2016.

During this period, the SEC brought a record-breaking 868 enforcement actions against companies and their executives and gatekeepers for alleged misconduct. Of this amount, the SEC targeted 160 ("the most ever") cases as involving investment advisers or investment companies. The SEC also brought 98 ("the most ever") standalone, or independent, cases involving investment advisers or investment companies. Add to this a record of 548 standalone enforcement actions, judgments and orders totaling more than $4 billion in disgorgement and penalties, a record $57 million distributed to whistleblowers during the fiscal year.

For additional insights, see our Client Alert here.

Are Your Customer Accounts in Order? SEC Announces Sweep of Broker-Dealers and Implementation of the Customer Protection Rule Initiative

On June 23, 2016, the SEC announced that it would begin a coordinated effort across divisions to identify potential violations by broker-dealers of Rule 15c3-3 (the "Rule") under the Exchange Act. As part of this effort, also known as the Customer Protection Rule Initiative (the "CPR Initiative"), the SEC will conduct a targeted sweep of broker-dealers and encourage firms to self-report any potential violations of the Rule. The CPR Initiative is intended to address historical or ongoing violations of Section 15(c)(3) of the Exchange Act and the Rule. The CPR Initiative covers only broker-dealers and provides no assurance that individuals associated with those entities will be offered similar terms if they have engaged in violations of the federal securities laws. The SEC may also recommend an enforcement action against such individuals beyond those available under the CPR Initiative. The SEC, however, did not specify for how long the CPR Initiative would run.

For additional insights, see our Client Alert here.

Double-Check the Math: Advisers Should Not Provide Clients With Performance Data Created by Other Investment Managers Without Verifying the Information

In a series of enforcement actions, the SEC made it clear that investment advisers need to substantiate the performance records of investment management firms they recommend to their clients. In these cases, failure to do so resulted in charges of spreading "false and misleading information" in violation of Section 206 of the Advisers Act.

Although presumably it is not necessary to recalculate performance data, the SEC staff said that when "an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact."

The SEC found in each case that the investment adviser negligently relied on performance information related to a separately managed account strategy managed by a third-party adviser. The advisers forwarded performance advertisements created by the third-party investment adviser without appropriately confirming the accuracy of the information in those advertisements. As a result, the SEC said, the advisers "failed to have a reasonable basis to believe that [the] performance was accurate," and they therefore distributed false and misleading advertisements to their clients in violation of Section 206(4) of the Advisers Act.

The advisers were also cited for failure to maintain books and records necessary to validate the performance claims.

Advisers are on notice, with these actions, that they cannot take performance claims of underlying advisers at face value. If performance is too good to be true, it just might be . . . too good to be true. The obligation for making sure that clients have full, fair and accurate information upon which to make investment decisions rests squarely with the adviser that has the client relationship. Reliance on information provided by others is, without verification, apparently not reasonable. Advisers should institute due diligence protocols to ensure that they are asking the right questions – and getting the right back-up – when it comes to performance data created by another entity.

Penalties assessed against 13 registered investment advisers caught up in the enforcement sweep ranged from $100,000 to $500,000. All 13 firms settled without admitting or denying the charges.

TIDBITS

- A copy of MoFo's *Uncertain Seas: European Financial and Regulatory Developments into 2017* is available here.
- A copy of MoFo's updated *A Financial Glossary: Making Sense of Alphabet Soup* is available here.
- On January 19, 2017, the SEC announced that SEC Chief of Staff Andrew J. "Buddy" Donohue will be leaving the agency. Mr. Donohue was named Chief of Staff in May 2015, and was a senior adviser to the Chair on all policy, management, and regulatory issues. Mr. Donohue had previously served as the Director of the SEC's Division of Investment Management from May 2006 to November 2010.

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