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The Three (Not So) Little Pillars of Effective Compliance Programs

By Erik K. Olsen

By now, most compliance professionals know the three pillars of an effective compliance program – **detect, correct, prevent**. This philosophy applies not only to a firm's implementing, monitoring, and testing of its compliance program, but it also applies to findings made during regulatory examinations. Compliance professionals (and their firm colleagues) cannot ignore compliance issues that arise, and certainly cannot ignore addressing and correcting issues once they are discovered. And least of all, firms cannot represent to their regulators that they will correct an issue, and well, not get around to doing so.

In early October, Stephen Cohen, Associate Director of the Securities and Exchange Commission's (SEC) Division of Enforcement, presented his thoughts on the culture of compliance which we can use to further set the stage for this article.[1] Mr. Cohen noted that it is most concerning to him when firms do not take compliance seriously until misconduct comes to light and management gives the impression that such issues are not important. Mr. Cohen also laid out his beliefs of what make problematic compliance programs and effective compliance programs. On the negative side, he sees (i) unempowered chief compliance officers, (ii) pushing the envelope, (iii) being simply in "technical compliance", and (iv) nonsensical explanations as problematic. On the positive side, he sees (i) proper governance, (ii) strong culture and values, (iii) rewarding of positive behavior, (iv) evidence of escalation, investigation and discipline, and (v) continual self-evaluation and improvements as hallmarks of effective compliance programs.

So how can firms avoid having compliance issues blow their houses down? There are many ways to structuring and creating a strong and well-implemented compliance program – some of which we will examine below.

Detect

Let us start with detection as the first pillar. Once you have established applicable policies and procedures based on the risks you identified at the firm (You did identify your compliance and regulatory risks, right?), compliance must ensure (i) the appropriateness of the policies and procedures, (ii) their effective implementation, and (iii) the adherence thereto by the firm and its personnel. Compliance is not the job of the compliance department; rather, compliance is the job of everyone at the firm. Compliance's job overall is to monitor the program, make improvements to the infrastructure, and make any general repairs or improvements as necessary to avoid future cracks. To do so, compliance needs to inspect the program on an ongoing basis. The compliance rule adopted in December 2003[2] requires at least annual reviews of a firm's compliance program. But this is a misnomer. Effective reviews, as with home inspections, take place during the course of the year. Pieces of the compliance program should be broken up, and reviewed and tested throughout the year. Firms should look to conduct testing on a monthly, quarterly, semi-annual, or annual basis depending on the risk factors for the firm and its clients. This also creates an opportunity to conduct in-depth reviews of smaller pieces, and allows compliance to utilize forensic testing.

Compliance should also look at outside influences on the compliance program. We live in a society where information comes fast and furious. Compliance should use this to its advantage. Constant monitoring of recent SEC enforcement actions, risk alerts from the SEC's examination staff, SEC staff and Commissioner statements regarding initiatives and priorities, and Division of Investment Management guidance (i.e., exemptive order adherence, risk management for fixed income investing[3]) will assist compliance in monitoring for potential cracks in the compliance foundation.

At the same time, compliance needs to enlist the help of its firm colleagues for "doing", and monitoring for, compliance. Firm personnel should know how to spot issues in their respective departments – be it finance or trading – and when to raise the issues to compliance. Compliance should have an open door to the firm, and should make itself aware of the happenings around the firm. This all leads to the detection of issues. The firm (and compliance) should establish a culture where employees are encouraged to speak freely without fear of being retaliated against (i.e., employee hotlines and whistle blower policies that can provide anonymity if necessary).

Correct

The second pillar concerns issue correction. Once an issue is detected, compliance should analyze the issue and determine the appropriate course of corrective action. Depending on the issue, compliance could solely do the repair work, or can seek additional assistance from the department where the issue was found. Either way, there needs to be a plan. Compliance should analyze (i) whether someone violated a policy, procedure, or regulation; (ii) whether the policy or procedures in practice do not meet the needs and function of the department or firm; (iii) the extent of the issue, and (iv) whether any clients were harmed. Once this is all assessed, then compliance can go to work.

1 *See Remarks at SSCE's Annual Compliance & Ethics Institute*, SEC Speech by Stephen Cohen, Associate Director, SEC's Division of Enforcement, October 7, 2013.

2 Author's note: Yes, it has been 10 years since the adoption of Rule 206(4)-7 under the Investment Advisers Act of 1940 and Rule 38a-1 under the Investment Company Act of 1940. Hard to believe, right?

3 *See* http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-02.pdf and http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf, respectively.

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Reflecting back on the release adopting the compliance rule, a chief compliance officer needs to be, in part,

> *empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient authority within the organization to compel others to adhere to the compliance policies and procedures.*[4]

As such, compliance should have the full authority to implement changes to the compliance program to correct (and further prevent) the identified issue and work with the department where the issue occurred to correct the matter. Of course the firm's senior management may also need to be involved in the correction of an issue, especially if the firm is going to have to reimburse the client for any loss incurred, but the compliance professional should be able to make the appropriate repairs.

While the methods to correct compliance breaches will be fact-specific depending on the breach and a firm's actual compliance program, two concepts generally will hold true – clients should be made whole for any losses suffered as result of a trade error, and the correction of a breach in one client's account cannot be cured at the detriment of another client. Compliance should monitor that the firm does not try to push ineligible securities in one account to another account, or consistently reallocate trades to another client just because it can. Any such instances should be supported by valid investment reasons and require compliance's pre-approval before doing so. Compliance should also monitor for patterns in such reallocations to see if one account consistently becomes the "go to" account for accepting another account's ineligible securities.

Ultimately, compliance's biggest goal is to actually address the issue. If an issue goes unaddressed, then the likelihood of it happening again increases, which in turn increases the likelihood that it becomes a bigger issue the next time. If you have found the leak, do not let it drip until it becomes a gaping hole that will burst at any minute. Unaddressed issues will not go away; on the contrary, they will most likely repeat themselves, or worse, will be found during a regulatory review. If a firm addresses such issues immediately the firm's exam will be cleaner and in many ways compliance and the firm will present the compliance program in a better light because the house is in good order.

Prevent

Now that your compliance program can detect and correct issues, what about preventing people from causing issues in the first place? Are hefty fines or the risk of losing their jobs strong enough deterrents? Well, yes and no. People need to be aware of the ultimate consequences they may face if they conduct a wrongful act, but studies have shown that these penalties in and amongst themselves do not stop the acts from occurring in the first place. What is more powerful is knowing that an individual will get caught. Knowing that a compliance program is in place – and that someone is monitoring the program – will be more helpful in preventing wrongful acts than just penalties alone.

Even the strongest compliance program needs a little assistance. In part, this comes from two places: (i) senior management and (ii) training. Through written codes of conduct and/or ethics, and their actions, senior management needs to set the moral and ethical tone of the firm. What they do, what they say, will be mirrored in the actions of the firm's employees. Senior management (or a star portfolio manager) cannot be held to a standard outside of the established ethics and compliance program. Such treatment will reflect negatively on the compliance culture and program of the firm and will be evident to firm employees and the SEC. A prior employer of mine had a great saying, "No chalk," which referred to the white boundary lines on a sports playing field. The firm did not want its business or employees getting near the boundary line – into that proverbial grey area – and especially did not want anything to

4 *Compliance Programs of Investment Companies and Investment Advisers*, IA-2204 (December 17, 2003).

cross out of bounds. Every employee knew this saying. It was coined by the firm's founder and repeated many times by him and senior management. It became part of the firm's moral and ethical culture.

Compliance training is also a big part of deterrence. Employees need to be trained about new policies and regulations, and reminded about current policies, practices, and regulations. Training should also occur when new employees are on-boarded, or when employees change job functions. Make compliance a standing agenda item on human resource's first day check list for new employees. This will give compliance the opportunity to speak about the firm's ethical culture and to set the expectations for compliance with firm policies.

To assist in getting the "message" delivered to employees, make training sessions "fun" as well as educational. Think of new ways to make the same point – play games, deliver quizzes, have employees spot grammatical errors or fun words in new policies (before they get implemented of course), create a theme to your training presentation based on a popular movie franchise – whatever it takes to get people interested and involved. Also, consider periodic reminders throughout the year as part of your training repertoire. Send reminders about the political contributions policy around election season, reminders about the gifts and entertainment policy around wedding season and the holidays, and reminders about the insider trading policy after a landmark enforcement action or criminal case.

Regulatory Promises

In her public appearances, SEC Chair Mary Jo White has spoken about the SEC's *Compliance Program Initiative*, a joint effort amongst examination, enforcement and policy staff members. The initiative focuses on firms that have failed to adequately respond to previous SEC deficiencies by (i) identifying compliance issues, (ii) providing firms an opportunity to address and correct the issue, and (iii) then reviewing the firm's remediation efforts.[5] If a firm fails to remediate the issue as it previously stated it would, or it simply ignores multiple warnings about the issue, then it will have bigger issues in facing the SEC's enforcement staff. This scenario was recently illustrated in three enforcement actions against firms that allegedly failed to heed prior warnings from the SEC staff.[6]

As with internal detection, if the SEC or another regulator identifies an issue, compliance and the firm should correct the matter and implement changes to prevent the issue from occurring again. In this case, provide the SEC's examination staff your plan of action in response to their findings, or better yet, the actual fix, and do it. Do not put off the repair until tomorrow, or next month, or next year. And worse still, do not put it off indefinitely. The next time the examination staff comes by your office in six months (and these Corrective Action Reviews are becoming more prevalent) or six years they will ask about the prior finding and remediation effort. It would be much more reflective of your effective program to show them, and your senior management for that matter, that the issue was fixed and is being prevented against going forward.

Detect, correct, prevent; these three (not so) little pillars are the building blocks of a strong and effective compliance program. To quote Mr. Cohen, "[You] will get much more credit from regulators by demonstrating that misconduct is an outlier in a highly ethical and compliance-driven culture than a remedial step after investors have suffered losses." ✦

5 *See* e.g., *Remarks at National Society of Compliance Professionals National Membership Meeting*, SEC Speech by Mary Jo White, Chair of the SEC, October 22, 2013.

6 *See* In the Matter of Modern Portfolio Management, Inc., et al., IA-3702 (October 23, 2013), In the Matter of Equitas Capital Advisors, LLC, et al., IA-3704 (October 23, 2013), and In the Matter of Stephen Derby Gisclair, IA-3703 (October 23, 2013).

The Volcker Rule Compliance Requirements:
Why Even Firms that are not Subject to Them Should Care

By Jeffrey O. Himstreet[1*]

The adoption of the rules to implement the restrictions contained in Section 619 of the Dodd-Frank Act,[2] commonly referred to as the Volcker Rule ("Volcker Rule" or "Final Rule"), is an administrative rulemaking marvel. With nearly 800 pages of explanatory text (the "Preamble"),[3] approximately 2800 footnotes and 70 pages of rule text, the Volcker Rule was adopted in late 2013 by three banking agencies (the FRB, OCC, and FDIC), and the SEC and CFTC (collectively, the "Agencies"). The Agencies received over 18,000 comment letters during the 3+ years since the Volcker Rule was initially proposed.[4] The Volcker Rule generally prohibits banking entities from engaging in proprietary trading and from sponsoring and/or investing in certain types of private funds, defined as "covered funds" by the Bank Holding Company Act ("BHC Act") and the Agencies.

Firms that are subject to the Final Rule are obligated to do far more than abide by prohibitions against certain types of trading or investing in certain types of funds: the Volcker Rule imposes significant compliance obligations on banking entities. The touchstone terms in the Preamble are "evidence" and "demonstrate" – each word appears more than 100 times, with the Agencies repeatedly emphasizing that if a firm is relying on an exemption from the Volcker Rule's prohibitions, of which there are many, the burden is on the firm to demonstrate – through its compliance program, reporting capabilities, and recordkeeping systems – that its reliance on the exemption is substantiated through its activities and intentions.

This article is the first of two, and will discuss the (a) firms that are subject to the Volcker Rule; (b) the Volcker Rule prohibitions generally; and (c) compliance requirements imposed by the Final Rule. The second installment, appearing in the March issue of *NSCP Currents*, will discuss specific, additional compliance requirements for firms relying on particular exemptions from the Volcker Rule prohibitions (for market making, underwriting, risk mitigation), and trade metric reporting requirements and the CEO attestation requirements. The March installment also will outline a process to consider when beginning to assess the scope of the firm's compliance efforts to enable it to meet the conformance requirements of the Final Rule. Even for firms that are not subject to the Volcker Rule, the compliance requirements and corporate governance standards imposed by it can be used as a baseline framework for a compliance program for any firm.

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A. What firms are subject to the Volcker Rule?

The Volcker Rule applies to "banking entities." A "banking entity" is generally:

- Any insured depository institution;
- Any company that controls an insured depository institution;
- Any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, as amended (the "International Banking Act"); and
- Any affiliate or subsidiary of the foregoing.

As a result, the definition of "banking entity" covers most types depository institutions, such as state-chartered banks, national banks, state and federally chartered savings associations, industrial banks, bank holding companies, savings and loan holding companies.[5]

1. Why should firms that are not banking entities care about the Volcker Rule?

The compliance requirements imposed by the Final Rule (discussed at Section C, below) can serve as a compliance program model for all firms, even those that are not subject to the Volcker Rule. As discussed in greater detail below, the compliance requirements of the Volcker Rule intertwine compliance obligations with corporate governance and business requirements. The Rule mandates a holistic, enterprise-wide compliance and risk management framework. It begins with the board and CEO setting the tone at the top, to implementation of the Volcker Rule requirements through procedures, monitoring, training, audit or other verification, and recordkeeping. Personnel of banking entities, beginning at the highest levels of the organization, are required to incorporate Volcker Rule compliance into performance goals and compensation standards for certain personnel to avoid violating the Volcker Rule's prohibitions. The corporate governance requirements are discussed in greater detail in the March sequel.

2. For firms subject to the Volcker Rule, when must they come into compliance?

The Volcker Rule became effective on July 21, 2012, but the statute provides for a two year conformance period. The FRB extended the conformance period, by one year, until July 21, 2015. During the conformance period, banking entities may continue to engage in activities covered by the Volcker Rule. However, a banking entity must engage in good-faith efforts, appropriate for its activities and investments, to conform of all activities and investments to the Volcker Rule by July 21, 2015.[6]

B .What generally does the Volcker Rule prohibit?

(i) *Proprietary trading* (subject to various exemptions and exclusions, discussed below);

(ii) *Covered fund ownership* (subject to various exemptions, discussed below);

(iii) *Compliance program requirements* (discussed below); and

(iv) *Trade metric reporting requirements* (discussed next month).[7]

1. Proprietary Trading

a. What is "proprietary trading"?

With limited exceptions, the Volcker Rule prohibits banking entities from engaging, as principal, in "proprietary trading". "Proprietary trading" is "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."[8] There is a prohibition on any activity that constitutes "proprietary trading" but is not excluded from the definition or specifically subject to an exemption.[9]

b. What investment types are subject to the proprietary trading ban?

A security (including an option on a security) as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act") is subject to the Volcker Rule prohibitions, as is a derivative (including an option on a derivative), and a commodity contract or option on a commodity.

Loans are excluded from the proprietary trading ban (unless they are tradable and then if so they are treated as securities). A commodity that is not an excluded commodity, a derivative, a contract of sale of a commodity or an option on a contract of sale of a commodity or foreign exchange or currency, is similarly excluded.[10]

c. Are there exclusions from the proprietary trading definition?

Yes. The BHC and the Volcker Rule contains limited exclusions from the proprietary trading definition. These exclusions, as does the Final Rule in its entirety, include a caveat from the Agencies that reliance on the exemption cannot constitute proprietary trading that is masked to look like something else. These include: repurchase agreements(which economically are more akin to loans than investments)[11]; securities lending and borrowing[12]; liquidity management (but only pursuant to a written liquidity management plan)[13]; clearing activities[14]; prevention of failed trades[15]; agency, brokerage or custodial activities[16]; securities purchases or sales made in employee benefit plans[17]; and acquiring securities to satisfy a previously-contracted debt.[18]

d. Are there types of proprietary trading that are exempt from the Volcker Rule Prohibitions?

Yes. As noted above, the proprietary trading prohibition is subject to various exemptions, including but not limited to exemptions for underwriting, market making, and risk mitigating hedging.

Underwriting. Underwriting activities are exempt, subject to numerous conditions to ensure that exempt underwriting activity is genuinely client-facing and designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties.[19] The underwriting exemption includes detailed compliance program requirements (again, discussed next month) that require *ex ante* trading desk limits (i.e., before the trade is made).

Market-Making. The Final Rule permits market makers to maintain and monitor overall "financial exposure" and "market-maker inventory" held by each trading desk at a firm.[20] The exemption includes a number of new or revised criteria, including that the trading desk "routinely stand ready" to trade, is "willing and available" to quote and otherwise enter into trades "throughout market cycles," and that market-maker inventory not be designed to exceed near-term demands based on, among other things, "demonstrable analysis" of historical customer demand. The Final Rule includes detailed compliance program requirements that also require *ex ante* limits on how each market-maker trading desk trades and hedges its risk, and will be discussed in detail in the second installment of this article, appearing in next month's *NSCP Currents.*

Risk-Mitigating Hedging. The Final Rule exempts hedging activity from the Volcker Rule prohibitions.[21] This exemption requires that hedging activity, at its inception, must demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks. Hedging activity cannot give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously. Hedging is permitted across affiliates, and dynamic and anticipatory hedging is permitted. The Final Rule includes detailed compliance program requirements (discussed in the second installment of this article) that require ex ante limits on hedging techniques and strategies, position and aging limits, correlation analysis and ongoing monitoring.[22]

Other exemptions from the prohibition are available for investments in US government, agency, and municipal obligations[23]; foreign government obligations[24]; transactions on behalf of customers[25]; transactions by regulated insurance companies[26]; and trading activities of foreign banking entities outside the united states.[27]

2. Covered Funds

a. What does the Volcker Rule prohibit as it relates to investments in funds?

Under the Volcker Rule, a banking entity is prohibited from sponsoring or acquiring or retaining, as principal, directly or indirectly, any ownership interest in a "covered fund."[28] The Final Rule clarifies that this prohibition does not apply to a range of scenarios where a banking entity is not acting as principal including, among other situations, where (i) the banking entity is acting solely as agent, broker, custodian, trustee or in a similar fiduciary capacity and the activity is on behalf of a customer and (ii) the interest is acquired through a deferred compensation, stock-bonus, profit-sharing or pension plan of a banking entity (or affiliate thereof).[29]

b. What is a "covered fund"?

The Final Rule generally defines a "covered fund" as (i) an issuer that would be an investment company, as defined in the Investment Company Act of 1940 ("Investment Company Act"), but for section 3(c)(1) or 3(c)(7) of that Act; (ii) certain commodity pools; and (iii) with respect to US banking entities only, certain non-US funds that would be required to rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act if offered in the US.[30]

c. What exclusions are available from the covered fund prohibitions?

Some Popular Exemptions. The Final Rule completely excludes from the definition of "covered fund," among others, (i) certain wholly-owned subsidiaries, joint ventures and acquisition vehicles; (ii) US registered investment companies (e.g., mutual funds), business development companies and issuers that rely on exclusions other than Section 3(c)(1) and 3(c)(7) of the Investment Company Act; (iii) foreign public funds and foreign pension funds; (iv) small business investment companies and public welfare funds; (v) certain insurance company separate accounts and separate accounts for bank-owned life insurance; and (vi) certain loan securitization vehicles, asset-backed commercial paper conduits and asset pools that cover the payment obligations of covered bonds.[31]

Exemptions for Sponsors of Customer Funds. Under the Final Rule, a banking entity may acquire or retain an ownership interest in, or act as sponsor to, a covered fund in connection with organizing and offering a covered fund for customers of the banking entity's bona fide trust, fiduciary, investment advisory or commodity trading advisory services (so-called customer funds).[32] In particular, there remains no requirement that there be a pre- existing relationship with the customer; however, the restrictions on name sharing between the banking entity and the covered fund remain. Banking entities also must adhere to a 3% limit on investments in each customer fund, and total investment across all customer funds is capped at 3% of a bank's Tier 1 capital.[33]

Foreign Banking Entities/Super 23A. Under the Final Rule, there remains an exemption from the covered fund prohibition for foreign banking entities with respect to certain covered funds that are "solely outside the [US]" (so-called SOTUS funds).[34] The Final Rule also retains the "Super 23A" provision banning a banking entity that serves as an investment adviser or sponsor to a covered fund from entering into any transaction with that fund if the transaction would be a "covered transaction" under Section 23A of the Federal Reserve Act, subject to limited exceptions.[35]

Even if an activity is permitted under the Volcker Rule may it still be prohibited?

Yes. Notwithstanding the exemptions for certain types of transactions involving covered funds, the Volcker Rule contains "backstop" provisions that, despite the availability of an exemption or exclusion, nevertheless prohibit transactions or other activity that would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties[36];
- Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy[37]; or
- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[38]

Under the Final Rule, a material conflict of interest exists between a banking entity and its clients, customers, or counterparties if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity.[39] The conflict of interest requirements would appear to address a scenario that became evident during the height of the financial crisis when an investment bank was assisting client A in constructing a derivative security based on the value of assets (e.g., mortgages) declining while advising Client B to purchase a derivative security based on the value of the same assets increasing.

To mitigate an actual or apparent conflict of interest, prior to effecting a specific transaction or class or type of transactions, or engaging in the specific activity, a banking entity may give clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[40] This disclosure must be made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest.[41] The practical effect is that boilerplate representations and warranties will likely be insufficient because the disclosure must be tailored to explain the conflict on a transaction-by-transaction basis.

Alternatively, a banking entity may establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. However, a banking entity may not rely on information barriers if it knows or should reasonably know that the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.[42]

3. Compliance Requirements

a. What do the compliance requirements impose?

The terms, scope and detail of the compliance program must be appropriate for the types, size, scope and complexity of the activities and business structure of the banking entity. Banking entities that engage in no proprietary trading are not required to maintain compliance controls related to Volcker. Those banking entities that have less than $10 billion in consolidated assets are permitted to leverage existing compliance controls and modify them as necessary to comply with the Volcker Rule. Banking entities with between $10 billion and $50 billion in consolidated assets must develop and implement a free-standing compliance program dedicated to Volcker Rule compliance, and those that have more than $50 billion in consolidated assets or that must report trade metric data (discussed below) must maintain so-called enhanced compliance controls.[43]

b. What must all Volcker Rule compliance programs contain?

All banks that are required to develop and implement Volcker Rule compliance controls must, at a minimum, include:

- *Internal Policies and Procedures.* Banking entities must adopt written policies and procedures reasonably designed to document, describe, monitor and limit exempted trading activities conducted by the banking entity (including setting, monitoring and managing limits required under the market making-related, underwriting and risk-mitigating hedging permitted activities) to ensure that all activities comply with the Volcker Rule.
- *Internal Controls.* Banking entities must develop a system of internal controls reasonably designed to monitor compliance and to prevent activities that are prohibited by the Volcker Rule from occurring.
- *Management Framework.* Firms subject to the Volcker Rule must develop, from the top down, a management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and that includes

appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the Volcker Rule or by management as requiring follow-up.

- *Independent Testing.* Banking entities subject to the Volcker Rule must conduct independent testing and audit of the effectiveness of the compliance program. This independent testing must be conducted periodically by qualified personnel of the banking entity (such as internal audit) or by a qualified outside party.
- *Training.* Banking entities must conduct training for trading personnel and managers, as well as for other appropriate personnel to effectively implement and enforce the compliance program.
- *Recordkeeping.* Banking entities must maintain and preserve records sufficient to demonstrate compliance with the Volcker Rule, which a banking entity must promptly provide to regulators upon request and retain for a period of no fewer than 5 years or such longer period as required by regulators.[44]

c. What additional requirements are imposed by banking entities subject to enhanced compliance requirements?

The enhanced compliance requirements build on the "standard" compliance requirements by requiring greater detail, greater reporting capabilities, and specific procedures addressing how the firm remediates violations. Banking entities that are approaching the thresholds to being reporting trade metric data or are approaching $50 billion in consolidated assets should consider whether develop a compliance program intended to satisfy the requirements for the enhanced compliance requirements to minimize the transition difficulties as the banking entity becomes subject to the enhanced compliance requirements. As discussed next month, the enhanced compliance requirements also carry with it trade metric reporting requirements and CEO attestation requirements, and it will be necessary firms that are subject to the CEO attestation requirements to begin mapping a process to develop support for the CEO attestation.

For banking entities subject to the enhanced compliance programs for proprietary trading must identify, document, monitor and report permitted trading activities, and promptly address risks and potential areas of noncompliance and prevent activities prohibited by, or that do not comply with, the Volcker Rule. Firms must also establish and enforce appropriate limits on covered trading activities, including limits on the size, scope, complexity and risks of the individual activities. Provide for periodic independent review and testing and ensure the internal audit, corporate compliance and internal control functions are effective and independent. Lastly, firms subject to enhanced compliance requirements must make senior management and others, as appropriate, accountable and ensure review of the compliance program by the Board and CEO (or equivalent), and facilitate supervision and examination by regulators of permitted activities.[45]

d. What specifically is required under the enhanced compliance requirements for proprietary trading?

A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of its permitted trading activities and the attendant risks. The firm must devote adequate resources and knowledgeable personnel, and the program must be updated with a frequency sufficient to account for changes in activities, testing results, identification of weaknesses, and to account for any legal/regulatory/other changes. The enhanced compliance program must be scalable and provide for revision before expanding trading activities. The enhanced compliance program must cover the following:

- written policies governing each desk that cover the financial instruments the desk may purchase and sell, the type of trading activity the desk may conduct, the risks that the desk may take on, and other information relating to the desk's trading activities.
- a comprehensive description of the entity's risk management program. This must include a description of the governance, approval, reporting, escalation, review and other extensive procedures used to ensure compliance with the Volcker Rule.
- limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in compliance with the law and the entity's policies and procedures. Risk limits must be based on specified criteria.
- the use of risk-mitigating hedging instruments and strategies.
- analysis and quantitative measurement of trading activities reasonably designed to ensure that the trading activity of each trading desk is consistent with the entity's compliance program. This includes any quantitative metrics specifically tailored to the banking entity's particular risks, practices and strategies.
- permitted trading activities, activities excluded from the definition of proprietary trading, high-risk assets and trading strategies and potential conflicts of interest.
- procedures for identifying violations of the Volcker Rule and require prompt documentation and remediation of any violation and document all proposed and actual remediation efforts. Records of any remediation activities must be available for inspection by regulators.

Written policies and procedures also must provide for assessment of the extent to which program modifications are needed and implemented, as well as prompt notification of material weaknesses or significant deficiencies in program design or implementation to senior management and the board of directors.[46] The independent testing, training, and recordkeeping requirements for the standard compliance program also apply to the enhanced compliance program requirements with additional detail surrounding the requirements. Independent testing of the compliance program, internal controls and management procedures, for example, must occur with a frequency appropriate to the size, scope and risk profile of the banking entity's trading and covered fund activities or investments, at least annually.[47]

Conclusion

The adoption of the Final Rule by the Agencies should be viewed by firms subject to the Volcker Rule as the beginning, rather than the end, of the process. The Final Rule marks the beginning of a lengthy process to implement the Volcker Rule and for banking entities to conform their activities accordingly. A broad range of interpretive issues will undoubtedly arise as the industry continues to develop a complete understanding of the consequences and practical implications of the Final Rule. Coordination among agencies is yet unclear in terms of their collective reaction to the inevitable need for guidance and/or relief. As noted at the outset, this article is the first of two that will appear in *NSCP Currents*. The second installment will cover the proprietary trading exemptions that require specific compliance procedures (market making, underwriting, and risk hedging), the trade metric reporting requirements, and the CEO attestation requirement, in addition to setting out a process for firms to consider following as they grapple with bringing their activities into compliance by the conformance date. For firms that are not subject to the Volcker Rule, the compliance and corporate governance framework can form the foundation for a holistic compliance program that can be adapted to address a variety of compliance challenges. ✦

(Endnotes)

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2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The Bank Holding Company Act amendments contained in Dodd Frank that constitute the Volcker Rule are codified at 12 USC §1841 et seq., and Section 13 is codified at 12 USC §1851.

3 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, SEC Rel. No. Release No. BHCA-1 (Dec. 10, 2013) (“Preamble”).

4 The Agencies other than the CFTC issued a proposed Volcker Rule implementing regulation in November 2011 (See 76 Fed. Reg. 68,846 (Nov. 7, 2011), and the CFTC issued a substantially similar proposed rule in February 2012 (See 77 Fed. Reg. 8,332 (Feb. 14, 2012) (referred to collectively as the “Proposed Rule”).

5 The Final Rule contains exclusions from the definition of “banking entity” for: any covered fund; any portfolio company held by a financial holding company in reliance upon the merchant banking authority in Section 4(k)(4)(H) or Section 4(k)(4)(I) of the Bank Holding Company (“BHC”) Act; and any small business investment company, provided that the fund itself is not a banking entity for some other reason, such as being in insured depository institution, an entity that controls an insured depository institution or a bank holding company. Final Rule §____.2(c)(2).

6 The FRB explained that such good faith efforts include evaluating the extent to which a banking entity’s activities and investments are covered by the Volcker Rule and developing and implementing a compliance program. The FRB also cautioned that banking entities should not expand their activities with the expectation that additional time to conform those activities to the requirements of the Volcker Rule may be granted. Banking entities may submit a request to the FRB for additional time to conform to the Volcker Rule.

7 The Volcker Rule requires firms with significant trading operations to report to the relevant Agency a number of quantitative measurements that are designed to assist the Agencies and banking entities in identifying prohibited proprietary trading that might occur in the context of exempt activities. Trade metric reporting will be discussed in the sequel to this article, appearing in the next issue of NSCP Currents.

8 Final Rule at § __.3(a).

9 See id. The Volcker Rule includes in it a rebuttable presumption that any position that is held for 60 days or less constitutes proprietary trading. This presumption can be rebutted if the banking entity demonstrates, based on all relevant facts and circumstances, that the banking entity did not purchase or sell the financial instrument principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, or realizing short-term arbitrage profits. Id. at § __.3(b)(2). There is no reverse presumption that would support a view that positions held for longer than 60 days are presumed to not constitute proprietary trading.

10 Final Rule at § __.3(c)(2).

11 Preamble at p. 57.

12 Final Rule at § ___.3(d)(2). The securities lending exclusion requires that the purchase or sale of financial instruments pursuant to a written securities lending agreement are excluded, but other positions (such as short positions or options) are not eligible for this exclusion and as such may involve proprietary trading.

13 Final Rule at §___.3(d)(3). In addition to the obligation to purchase and sell securities pursuant to a written liquidity management plan, the securities themselves are limited to highly liquid securities that are not associated with appreciable profits derived from short term trading (the highly liquid securities would typically include cash equivalents).

14 Final Rule at §___.3(d)(4)-(5).

15 Final Rule at §___.3(d)(6).

16 Final Rule at §___.3(d)(7).

17 Final Rule at §___.3(d)(8).

18 Final Rule at §___.3(d)(9).

19 Final Rule at § ___.4(a)(2).

20 Final Rule at §___.4(b).

21 Final Rule at §___.5(b).

22 Additional documentation standards apply to hedges that are established at a different trading desk than the desk that established the underlying position, across trading desks and for hedges that exceed pre-determined limits. The Final Rule’s hedging exemption retains the statutory language that provides flexibility for banking entities to hedge “individual or aggregated positions,” but the release discusses types so-called “portfolio hedging” that are not permitted, such as making general bets on interest rates or a market index that are not correlated to specific portfolio risk exposures. See Preamble, at §IV.A.4.d.

23 Final Rule at § ___.6(a).

24 Final Rule at § ___.6(b).

25 Final Rule at § ___.6(c)(2); see also Preamble at pg. 396.

26 Final Rule at § ___.6(d).

27 Final Rule at § ___.6(e).

28 Final Rule at § ___.10(a)

29 Final Rule at § ___.10(a)(2).

30 Final Rule at § __.10(b). Compared to the proposed rule, the agencies have significantly scaled back the scope of commodity pools and non-US funds that are included in the definition of “covered fund.” In particular, with respect to investments or sponsorship by foreign banking entities, non-US funds that are not offered into the United States and, therefore, are not required to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act are no longer “covered funds.”

31 Final Rule at § ___.10(c).The Final Rule expressly provides that the covered fund prohibition does not apply to the acquisition or retention by an insurance company or an affiliate therefore of any ownership interest in, or sponsorship of, a covered fund if the insurance company or affiliate acquires and retains the ownership interest solely for the general account or one or more separate accounts of the insurance company in compliance with and subject to insurance law and regulation. See id.; see also Preamble at §IV.A.7.

32 Final Rule at § ___.11.

33 Final Rule at § ___.12(c)(2).

34 Final Rule §___.13(b)(5). The requirements of the SOTUS exemption include that (i) the banking entity and the relevant personnel making sponsorship or investment decisions are not located in the United States, (ii) the sponsorship or investment is not accounted for on a consolidated basis by any branch or affiliate of the foreign bank in the United States, (iii) no financing for the foreign bank’s sponsorship of or investment in the fund is provided by any branch or affiliate located in the US or organized under US law and (iv) no ownership interest of the covered fund is offered (or has been offered) to US residents. See Preamble at §IV.A.8.

35 Final Rule §____.14. The scope of Super 23A, however, has been reduced by the exclusions from the definition of covered fund (discussed above), including exclusions for wholly-owned subsidiaries and registered investment companies.

36 Final Rule §___.15(b).

37 The Final Rule defines a high-risk asset as an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the US. Final Rule §___.15(c)(1). It defines a high-risk trading strategy as a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Final Rule §___.15(c)(2).

38 Final Rule §____.15.

39 Final Rule §____.15(b).

40 Final Rule §____.15(b)(2)(i).

41 Final Rule §____.15(b)(2)(i)(B).

42 The above-prohibition may apply even if the banking entity established information barriers. See Final Rule §____.15(b)(2)(ii).

43 Final Rule §____.20(c) (referencing Appendix B to the rule text, which outlines the enhanced compliance program requirements in detail).

44 The compliance requirements are specified in Appendix B of the Volcker Rule and are discussed at § IV.C.2. of the Preamble.

45 Final Rule ___§.20(c), Appendix B; see also Preamble, at §IV.C.2.

46 Id.

47 Id.

Duties and Obligations for Investment Advisors in Agency and Principal Cross Trades under Rule 206(3)

By Julie Kang

Introduction

The current business and regulatory landscape suggests increased trading by fee-based investment advisors. Market uncertainty over interest rates and inflation, and greater interest in alternative investments, suggests that investment advisors may need to rebalance and reallocate clients' portfolios with greater frequency. Also, on December 6, 2012, the U.S. Securities and Exchange Commission ("SEC") lifted a 2.5 year moratorium on exemptive requests for actively-managed exchange-traded funds ("ETF's) use of derivatives. However, legal and compliance personnel face heightened regulatory concerns with potential increased trading by investment advisors pursuant to the 1940 Investment Advisor's Act's Rules 206(3).

A cross trade is defined as a transaction between two accounts managed by the same investment advisor, on either an agency or principal basis. Regardless of whether the cross trade is on an agency or principal basis, the investment advisor has control (discretion granted by the client(s)) over opposite sides of the trade. However, in an agency cross trade, the investment advisor does not have ownership of either side of the trade whereas in a principal cross trade, the investment advisor does have ownership of one side of the trade. In an agency cross trade, the ownership on opposite sides of the trade are both advisory client(s), or are an advisory client on one side of the trade and a brokerage customer on the other. In a principal cross trade, the ownership on one side of the trade is for the investment advisor and advisory client(s) on the other.

Regulatory Concerns over Cross Trades

Cross trades are controversial. On the one hand, crossing trades provides benefits for clients by lowering transaction costs, preventing slippage, and possibly providing prices unavailable on the market. On the other hand, crossing trades pose conflicts of interest and potential self-dealing in contravention of fiduciary dut(ies) and duty of best execution for securities and due diligence for derivatives, for investment advisors. Cross trades on an agency basis can lead investment advisors to favor some clients over others to the detriment of the un-favored investment advisory/brokerage client(s). Such prejudice can be motivated by greater compensation or potential business opportunities posed by giving better prices and fills to one client over another, potentially even leading to excessive trading and churning. Cross trades on a principal basis can lead investment advisors to allocate better prices and/or products to their own accounts, potentially even leading to "dumping" undesirable products in client(s) account(s).

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As cross trading involves not only customer money on one or both sides of the trade, but also fiduciary duty on one or both sides of the trade, regulators are concerned with potential manipulation and fraud. The difference between manipulation and fraud is that manipulation is harm to the markets, whereas fraud is harm to customers. Generally, sanctions against fraud are greater than manipulation.

Investment advisors' agency cross trades are subject to Rule 206(3)-2: Agency Cross Transactions for Advisory Clients, and investment advisors' principal cross trades are subject to Rule 206(3)-3T: Principal Trades with Certain Advisory Clients. Both Rules 206(3)-2 and 206(3)-3T fall under § 206: Prohibited Transactions by Investment Advisors of the 1940 Investment Advisors' Act. § 206 is an anti-fraud and anti-manipulation provision, and as such, has same/similar language to the 1934 Securities and Exchange Act's Rule 10b-5, the SEC's general catch-all anti-fraud and anti-manipulation provision against the purchase and sale of securities. Rule 206(3) applies to investment advisors, and broker-dealers affiliated with investment advisors. The SEC's Release No. IA-1732: Interpretation: Interpretation of § 206(3) of the Investment Advisors Act of 1940 provides additional guidance on compliance with Rules 206(3)-2 and 206(3)-3T.

Duties and Obligations under Rules 206(3)-2 and 206(3)-3T *Disclosure*

Legal and compliance personnel need to be aware that despite the onerous disclosure requirements that investment advisors are generally subject to, investment advisors conducting cross trades are subject to *separate* and *additional* disclosure requirements to clients under Rules 206(3)-2 and 206(3)-3T that are different from the disclosure requirements of Form ADV-Part II pursuant to Rule 204-3, material information regarding compensation pursuant to Rule 206(4)-4, § 206(1), § 206(2), and any other disclosure obligations under state and/or federal securities laws.

Both agency and principal cross trades require written confirmation at or before the completion of each trade with at least the following four elements: the nature of the transaction, trade date, compensation, and an offer to furnish trade time upon client request. The most obvious remuneration includes transaction-based, fee-based, management fees, and performance-based compensation However, "compensation" also includes other compensation received and/or directed by investment advisors in connection with cross trades such as payment of order flow and soft dollars. Both agency and principal cross trades require written annual account statements that disclose at least the following two elements: total number of transactions since the last annual account statement and total amount of compensation received by the investment advisor.

The major differences between agency and principal cross trades are in written disclosure and written consent. Cross trades require written disclosure of any actual or potential conflicts of interest, and transaction-based brokerage or fee-based commissions to be received. And, cross trades require written consent of cross trades from client. However, agency cross trading only require written disclosure and written consent only once, upfront, and prior to trading at the start of the *investment advisor-client relationship*. Because of the greater conflict of interest and potential for self-dealing in principal cross trades relative to agency cross trades, principal cross trades require written disclosure and written consent prior to each and every *principal cross trade*.

All confirmations and written statements must include a "conspicuous statement" that written consent may be revoked at any time with written notice to the investment advisor.

Fiduciary duty

Both Rules 206(3)-2(c) and 206(3)-3(b) contain nearly identical language that goes as follows:

> This shall not be construed as relieving in any way the investment advisor from acting in the best interests of an advisory client, including fulfilling the duty with respect to the best price and execution for the particular transaction for the advisory client.

In other words, no amount of disclosure or clients' written consent absolves investment advisors from their fiduciary dut(ies), best execution for securities, and due diligence for derivatives, to their clients.

Rules 206(3)-2 and 206(3)-3T in Practice
Heightened Monitoring for Cross Trading

There are particular times of the year when investment advisors are more likely to cross trades and thus, legal and compliance personnel should be on heightened alert. Investment advisors are more likely to execute orders on opposite sides of the market during rebalancing dates of the major indices. Major rebalancing dates occur at month's end. One of the most significant ones, known as the Russell Reconstitution, has occurred in the middle of the year since 1984. In 2013, the Russell Reconstitution occurred on June 28, 2013. Closer towards the end of the year also could result in heightened trading activity by investment advisors. Rebalancing is a portfolio risk management strategy that sometimes is counterintuitive by requiring investment advisors to close out positions at a loss and, in doing so, provides tax benefits. End of the year also is prior to the printing of annual account statements.

There are particular times of the day when investment advisors are more likely to cross trades, such as the NYSE's open at 09:30(ET) and close at 16:00(ET). 09:30(ET) and 16:00(ET) results in the opening and closing cash print and are static, not dynamic, points in time. For a variety of reasons, including to hedge portfolio positions, investment advisors commonly like to get the cash prints. There are particular products that are more susceptible of crossing. In the underlying cash market, stocks and bonds are perceived to be suitable for a variety of clients. In the derivatives markets, stock index and interest rate/Treasury futures are perceived to provide viable hedges for underlying cash positions. As these are hedges that may need to be placed or unwound, liquidity and depth is of utmost importance. The E-Mini S&P 500 Futures are the most liquid and deep of stock index futures. And, the Eurodollar futures are one of the most liquid and deep of interest rate/Treasury futures.

Enforceability of Rules 206(3)-2 and 206(3)-3T

Two of the SEC's more recent settlements on cross trading was In the Matter of BNY Mellon Securities LLC, Administrative Proceeding File No. 3-14191, Exchange Act Release No. 63724 (January 14, 2011) with its companion case, In the Matter of Mark Shaw, Administrative Proceeding File No. 3-14192, Exchange Act Release No. 63725 (January 14, 2011), and In the Matter of Piper Capital Management, Inc., Advisers Act Release No. 1435 (Aug. 11, 1994).

Mark Shaw, an institutional order desk manager at BNY Mellon Securities LLC ("BNY Mellon"), allegedly favored accounts belonging to individuals and hedge funds over accounts belonging to 700 plan customers (including employee stock purchase and employee stock option plans) in over 80% of the trades from November 1999 to March 2008. Despite that BNY Mellon self-reported so that BNY Mellon's civil penalty was only $1 million in light of its "cooperation," BNY Mellon was liable for an additional $23 million ($19.3 million in disgorgement and $3.7 million in prejudgment interest). Mr. Shaw was liable for a civil penalty of $150,000 and $218,591 in disgorgement. The majority of the sanctions ($23 million) was because of the egregious and extensive nature of the cross trading, as the SEC had found evidence of customer harm (classic fraud) and breach of fiduciary duty occurring for nearly a decade. Piper resulted in a $2,005,000 civil penalty for fraudulent statements, omission of material facts, fraudulent pricing of net asset value, and falsification of reports. The SEC had found evidence of failure to properly disclose. Note that failure to properly disclose was considered "fraud."

However, a recent FINRA case, FINRA v. Richard E. Morrison, 200813863702 (August 28, 2012) suggests a mitigating factor and possibly even a defense. In Morrison, Morrison conducted agency cross trades without proper disclosure. However, the court dismissed because the disclosure was supposedly not "material" and the clients actually *benefited* from the cross trading.

Conclusion

The role of investment advisors managing trading of client accounts will grow with the increase in fee-based business, and recent market events that challenges the traditional 60/40 model. However, this suggests that, moving forward, the role of legal and compliance personnel should also grow in tandem to ensure proper compliance with federal securities laws.✦

So You Want to Be a Crowdfunding Portal? Top 10 Traps for the Unwary

By Eliza Sporn Fromberg and Michael J. Burwick

While both startups seeking capital and investors on the prowl for the next big thing have been quick to endorse equity crowdfunding, there's a third group that sees exciting opportunities in this new capital fundraising scheme: prospective funding portals. This year, we'll witness the creation of entirely new regulated entities[1] that will facilitate the sale of crowdfunded securities to both accredited and non-accredited investors – without being subject to the extensive regulatory framework governing broker-dealers. Thinking of launching a website to offer crowdfunded securities? Based on proposed Regulation Crowdfunding, the rules prescribed by the Securities and Exchange Commission ("SEC") to implement the requirements of Title III of the JOBS Act, here are some things to keep in mind before you rush out to register some variant of "www.iLuvCrowdfunding.com."

1. You're Not a Broker-Dealer – So Don't Act Like One

Funding portals have extremely limited functions. Their sole purpose is to act as intermediaries in transactions involving the offer or sale of crowdfunded securities. Without registering as a broker-dealer or an investment adviser, a funding portal cannot offer investment advice or recommendations. For example, a funding portal is not permitted to highlight "recommended" offerings, describe interesting or novel offerings, or even decide which companies can make offerings on its website based on other than objective criteria, such as offerings in a particular industry. Focusing on an "offering of the day" or simply placing a particular offering in a prominent position on a webpage could appear to be an implicit endorsement of the offering or issuer, thereby constituting investment advice.

2. No Handling the Merchandise

How are you planning to compensate yourself? Funding portals may earn commissions based on the amount of money that is raised for issuers, but beyond that, their options for making money on crowdfunded offerings are limited. If you thought that your funding portal (or its directors, officers and partners) would take an equity stake in the issuer as compensation for the services the portal is providing in connection with the offer and sale of securities, think again. Moreover, the funding portal and its directors, officers and partners are prohibited from having any financial interest in an issuer using its services. This proposed rule, which would prohibit the director of a portal from investing in the companies on the portal, is intended to eliminate cherry-picking by advancing one issuer's fundraising efforts over those of another issuer.

3. Not Just Anyone Can Play on Your Field

Funding portals are required to conduct certain diligence on prospective issuers seeking to list their offerings on the portal's website. The funding portal must have a reasonable basis for believing that an issuer seeking to offer and sell securities through the portal (1) complies with the requirements in Securities Act Section 4(A)(b) and the requirements in Regulation Crowdfunding; and (2) has established means to keep accurate records of its security holders. The portal may reasonably rely on the issuer's representations as to its compliance, unless the portal knows or has reason to know that the representations are false. Portals dealing with unsophisticated issuers may need to take steps to confirm the issuer's representations.

Portals play a gatekeeper role. If the portal believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection, the portal must deny access to its platform. The portal must conduct a background and securities enforcement regulatory history check on each issuer as well as each of its officers, directors or 20 percent beneficial owners, but beyond this requirement, the proposed rules do not specify actions that a portal must take to reduce the risk of fraud. If the portal is unable to assess the risk of fraud – for example, if it cannot obtain background check information on certain officers of an issuer – the portal is required to deny access. Similarly, if the portal has a reasonable basis for believing that an issuer (or any of its officers, directors or 20 percent beneficial owners) is subject to a disqualification under the proposed rules, the portal must deny access to its platform. If the portal learns of the potential for fraud after the offering is already posted to the website, the portal must promptly remove the offering from the site, cancel the offering and return to investors any funds they may have committed.

4. It's Your Responsibility to Educate Your Investors

The proposed rules require the portal to provide educational materials about crowdfunding to every potential investor opening an account with the portal. Among other things, the materials must contain basic terms about crowdfunding transactions, including

1 A funding portal must register with the SEC pursuant to Securities Act Section 4A(a)(1) and proposed Rule 400 of Regulation Crowdfunding. In addition, a funding portal must register with FINRA and is subject to FINRA's proposed funding portal rules. See Regulatory Notice 13-34 (Funding Portal Rules). The comment period on both the SEC's and FINRA's proposed rules closed on February 3, 2014.

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limitations on investment amounts, the circumstances under which an investor can cancel an investment commitment and obtain a refund, and the restrictions on the resale of crowdfunded securities.

But don't think that you can send the materials and consider the potential investor educated. The portal must ensure that each investor reviews the educational materials. As a substitute for watching the investor actually read the materials, the proposed rules require the portal to have the investor affirm that he/she understands that he/she is risking the loss of the entire investment and that he/she could bear such a loss. The portal is required to collect the investor representation and completed questionnaire each time before accepting any investment commitment. This requirement is intended to help make certain that investors engaging in crowdfunded transactions are fully informed and reminded of the risks associated with their particular investment before making any investment commitment.

5. Don't Breach Crowdfunding Chat Room Etiquette

The portal is like a big chat room for potential investors and issuers. The proposed rules require the portal to provide channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the portal's platform. These communications, in which the "wisdom of the crowd" is presumably revealed, are intended to help potential investors assess the issuer and the investment opportunity. To promote transparency and accountability, all communications between investors and the issuer about the terms of the offering are required to flow through the portal. Portals themselves can't join in the discussions – apart from establishing guidelines for communication and removing abusive or potentially fraudulent communications. To keep the discussion honest, any commenter who is a founder, officer, director or employee of the issuer or is being compensated (directly or indirectly) to promote the issuer's offering is required to identify himself/herself as such and disclose the receipt of compensation each time the commentator makes a promotional communication. Portals are well placed to ensure that promoters are clearly identified in postings.

6. You Could Be Liable for the Issuer's Misrepresentations

An issuer will be liable to a purchaser of crowdfunded securities if the issuer, in the offer or sale of securities, makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading – unless the purchaser knew of the untruth or omission or the issuer did not know, and in the exercise of reasonable care could not have known, about the untruth or omission. The SEC has stated that it appears likely that funding portals would be considered issuers for purposes of this liability provision. In order to address this potential liability, funding portals will need to establish due diligence policies and procedures and consider reviewing the issuer's offering documents to evaluate whether they contain materially false or misleading information.

7. Beware of Fickle Investors

Investors have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the issuer's offering materials. This flexibility is intended to allow investors to have the full benefit of the views of other potential investors regarding a crowdfunded offering, even after the investor has made a commitment. If an issuer fails to complete an offering because the target is not reached or the issuer decides to terminate the offering, the portal must, within five business days, give each investor who had made an investment commitment a notification disclosing the cancellation of the offering, the reason and the refund amount that the investor should expect to receive; direct the refund; and prevent investors from making investment commitments with respect to that offering on its platform.

8. Don't Jump the Gun on Transmitting Funds to the Issuer

Pursuant to the proposed rules, funding portals would be required to direct investors to transmit money or other consideration directly to a bank that has agreed in writing to either hold the funds in escrow for the benefit of the investors and the issuer, and to promptly transmit or return the funds to the persons entitled to such funds, or to establish a bank account for the exclusive benefit of investors and the issuer.

When the aggregate amount of investment commitments from all investors is equal to or greater than the target amount of the offering, and the cancellation period for each investor has expired, the portal must promptly direct transmission of funds from the bank to the issuer. However, keep in mind that issuer information must be available to investors for at least 21 days prior to the first day on which securities are sold and that investors must be allowed a reasonable opportunity to rescind their investment commitment. Accordingly, the transmission of funds can take place no earlier than 21 days after the date on which the portal makes publicly available on the website the information required to be provided by the issuer, such as information about the issuer and the offering.

9. Remember the Receipt

Upon receipt of an investment commitment from an investor, the portal is required to promptly provide the investor with a notification disclosing the dollar amount of the investment, the price of the securities, the name of the issuer, and the date and time by which the investor may cancel the investment commitment.

At or before the completion of the transaction, the proposed rules require the portal to provide each investor with a confirmation of the transaction that includes, among other things, the transaction date, the type of security, the price and number of securities purchased, the number of securities sold by the issuer in the transaction, the price at which the securities were sold, and certain specified terms of the security. The confirmation must include the source and amount of any remuneration received or to be received by the portal in connection with the transaction, whether from the issuer or any other person. This requirement is intended to highlight potential conflicts of interest the funding portal may have.

10. Registration and Ongoing Requirements

While the proposed SEC rules and proposed FINRA rules governing the registration and compliance obligations of funding portals are certainly less extensive than the rules pertaining to broker-dealers, these new entities are still heavily regulated. The proposed SEC rules require a prospective funding portal to file a "Form Funding Portal" with the SEC. The information sought is consistent with, but less extensive than, the information required for broker-dealers on Form BD. For example, Form Funding Portal would require information regarding the portal's ownership and management, including disciplinary history. The portal would also need to register with FINRA, pursuant to the FINRA proposed rules, and would be subject to FINRA conduct requirements for funding portals.

Conclusion

Do the benefits of acting as a funding portal outweigh the compliance costs and the risk of potential liability? Even though funding portals may earn transaction-based compensation, the proposed limit of $1 million on the amount that an issuer may raise in a 12-month period by issuing crowdfunded securities will require a successful funding portal to feature a large number of offerings. As a consequence, the funding portals that make a strong impression with issuers and investors in the early days of crowdfunding – and that have the sophistication to avoid regulatory pitfalls – will have a significant advantage in the race to become the portal of choice. ✦

To read Ms. Fromberg's and Mr. Michael J. Burwick's White Paper entitled, "Top 10 Traps for the Unwary Crowd-Funding Portal" please click here.

Muni Time of Trade Disclosure – Why a New Rule and Why the Delay?

Technology and The Desire to Maintain Guidance from the Past

By Gregg Bienstock, Esq.

The objective of the rule is simple: protect the retail investor. And, when it comes to the municipal market, the rule already exists. So why is Proposed Rule G-47 pending approval by the SEC, and how will it differ from the existing rule? Why is this well-intentioned and, as some believe, needed Rule the subject of an SEC Order that has delayed its implementation?

Let's start with the existing "Fair Dealing" Rule. MSRB Rule G-17, is a simply written rule that has been the subject of a significant amount of interpretive guidance and letters over the past 30 years. In 2010, FINRA, in an attempt to bring some semblance of order to this plethora of guidance, issued its Regulatory Notice 10-41, also known as "The Checklist." The Checklist was meant to provide market participants a level of clarity around the requirement of dealing fairly with non-sophisticated and retail investors. At the same time, the MSRB issued a notice reminding market participants of their obligations and its interpretive guidance issued over the years.

In February 2013, the MSRB, in an effort to create a rule that "would ease the burden on dealers and other market participants who endeavor to understand, comply with and enforce the time of trade disclosure obligation" introduced Proposed Rule G-47[1]. The Proposed Rule, as the MSRB notes, is in response to feedback of market participants "who have expressed concern regarding the difficulty of reviewing years of interpretive guidance to determine current obligations." So what has happened and why isn't G-47 on the books?

Proposed Rule G-47, is a free-standing rule seeking to codify the relevant interpretive letters and guidance of G-17 around the time of trade disclosure obligation. In the proposed rule and request for comment, the MSRB made clear:

> *Proposed Rule G-47 would codify the principles from these interpretive notices without changing the time of trade disclosure obligation.*

...“what was ‘reasonably accessible’ even a year or two ago has changed. Technology has evolved as have the ways in which to ensure your firm’s practices are in line with the policies”.

The MSRB, in its proposed rule filing with the SEC, responded to the comment letters it received making clear the proposed rule was meant to codify the existing interpretive guidance and letters and not create new or different requirements. The MSRB noted that, to the extent new requirements were suggested in the letters or if the MSRB were to suggest new requirements, the same would be proposed and addressed at a later time. In other words, the MSRB was sticking to its word — make it clear for those that want to comply and for those that enforce these rules.

The SEC published the proposed rule, two comment letters were submitted and the MSRB responded to both. On January 16, 2014, the SEC issued an Order seeking "additional input from interested parties on the MSRB's proposed change in its treatment of past interpretive guidance.[2]

> ...the MSRB proposed the deletion of certain interpretive guidance affected by these rule changes from the MSRB's Rule Book... [T]o address a commenter concern, the MSRB states that it will archive on its website the existing guidance that is to be deleted from the Rule Book in connection with the proposed rule change. [Citation omitted] Moreover, the MSRB states that "[t]o the extent that past interpretive guidance does not conflict with any MSRB rules or interpretations thereof, it remains potentially applicable, depending on the facts and circumstances of a particular case" (together with the archiving on its website of the existing guidance that is to be deleted under the proposed rule change, this approach is referred to herein as "the MSRB's proposed treatment of past interpretive guidance.") The MSRB notes, however, that preserving the guidance at issue in the Rule Book itself would undermine the MSRB's goal to provide streamlined rule language.

The MSRB was responding to a commenters' request that time of trade disclosure interpretive notices be maintained because "there are nuances contained in these interpretive notices spanning over 30 years of guidance that brokers, dealers, and municipal securities dealers have long relied upon.[3]

The delay in the SEC ruling on this Proposed Rule, while warranted under the applicable rules, falls under the category of "no good deed goes unpunished." In an effort to appease a reasonable comment from SIFMA, the MSRB offered a seemingly logical and balanced alternative. The problem is that the alternative proffered deviated from the original proposed rule. Thus the delay, the extent of which will not be known for, at least, a few more weeks.

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Irrespective, it seems one can have a high level of confidence that the substantive requirements of the proposed rule, the codification and embodiment of G-17 and the associated interpretive guidance and letters, will survive.

All of which leads back to technology. Why? The answer is fairly simple: the rule is a consolidation and codification of G-17 and its interpretive notices and guidance around time of trade disclosure. The obligation was and is to "disclose material information that is reasonably accessible." What was "reasonably accessible" even a year or two ago has changed. Technology has evolved as have the ways in which to ensure your firm's practices are in line with the policies. While firms periodically review their policies and procedures, the introduction of a codification of hard to decipher guidelines should be cause to revisit existing policies and practices. Have your policies and practices kept up with available technology and resources?

Technology brings to the fore two realities.

1. It has made more and better information available. As noted above, what is "reasonably accessible" today is very different than what fit this category one, three or five years ago.

   Do those dealing with your retail clients have real-time access to material information for communication to the client at or before the time of trade? Is it current? Is it in one place for ease of use and delivery? Are you sure they disclosed all the required information? How? Checking the box? With the introduction of enhanced technology, is that the best way to ensure your firm's policies are indeed practiced, especially as we hear regulators talk more about seeing proof? Can you easily and efficiently access information to answer the question of whether or not the material information was disclosed at or before the time of trade? This leads to the second reality around technology.

2. FINRA and the SEC have made clear that technology coupled with data examination and review will be an important part of the examination and enforcement protocol. They now have the data and technology to better identify the types of activity that may be riskier based on market or individual behavior and focus their examination in ways previously not available.

Combine the advances in technology with the reality that there is clarification around what is required to be disclosed and you have a changed landscape in terms of what is available and what is to be disclosed. A quick read of Proposed G-47 (and the interpretive guidance associated with G-17) makes clear that a simple review of past material event disclosure filings or an OS summary from the time of issuance will fall short of "material information reasonably accessible."

Advances in technology and clarity around the time of trade disclosure obligation for your non-SMMP and retail client are cause to revisit your policies and actual practices. Have you kept up with technology, or will the regulator be a step ahead? ✦

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1 MSRB Notice 2013-04 (2/11/2013).

2 SEC Order "Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change Consisting of Proposed MSRB Rule G-47, on Time of Trade Disclosure Obligations, Proposed Revisions to MSRB Rule G-19, on Suitability of Recommendations and Transactions, Proposed MSRB Rules D-15 and G-48, on Sophisticated Municipal Market Professionals ("SMMPs"), and the Proposed Deletion of Interpretive Guidance."
SEC Release No. 34-71326; File No. SR-MSRB-2013-07, January 16, 2014

3 Letter from David Cohen, SIFMA, 11/12/2013.

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