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NSCP ✦ CURRENTS

INSIDE THIS ISSUE

Applying Newman's Personal Benefit Requirement to Insider Trading Compliance Programs 3

Secondary Trading in JOBS Act Securities 6

Social Media – Compliance Risk Management Considerations 11

Key Risks Facing Private Equity Fund Managers Series 13

The Complexities of Distributing Complex Products 15

Simons Says: Triple Play 17

MSRB Series 50 Pilot 19

New Members 20

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This month's issue of ***NSCP Currents*** reviews the effects of United States v. Newman as it has affected enforcement activity and other decisions, and offers several solid compliance takeaways worth noting. "Secondary Trading in JOBS Act Securities" discusses the effects that the Act has on the regulatory environment with its limitations and implications. Social Media is here to stay in our business, and "Social Media – Compliance Risk Management Considerations" offers a review of the literature as well as a list of risk management controls.

We introduce a three part series for Private Fund Managers on key regulatory risk areas with the first article discussing Performance Presentations. "The Complexities of Distributing Complex Products" discusses training requirements, suitability assessments among other responsibilities. Finally, the new installment in the Simon Says series discusses three topics on every Investment Adviser's radar.

This issue includes an announcement from the **MSRB** concerning the **Pilot Series 50 exam**. The message includes links to the exam outline and other resources.

Registration is now open for the 2015 National Conference. In the **WHAT'S NEW!** section, you'll find a link to the registration page as well as a link to the new Best Practices Survey and upcoming free webinars.

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Applying Newman's Personal Benefit Requirement to Insider Trading Compliance Programs

By Marc D. Powers & Jonathan A. Forman

The U.S. Court of Appeals for the Second Circuit's decision in *United States v. Newman*[1] has had significant implications for both criminal and civil insider trading prosecutions. At bottom, this decision makes it more difficult for the government to be successful in actions against alleged remote tippees (like the *Newman* defendants who were three or four persons removed from the tipper) with insider trading by requiring that they have knowledge of a *quid pro quo* relationship between the tipper and the initial tippee.[2]

While many criminal defendants have been able to avail themselves of *Newman* to dismiss insider trading charges, vacate convictions, or reduce penalties, other defendants in civil cases brought by the U.S. Securities and Exchange Commission ("SEC") have not been as successful and despite the limitations *Newman* places on insider trading prosecutions, the government still seems to be pursuing insider trading cases as a high priority.

In light of these developments, hedge funds, investment banks, and other money managers should revisit their insider trading compliance programs to ensure they are consistent with *Newman* and the cases interpreting it.

United States v. Newman

As a result of a far-reaching criminal insider trading investigation, the U.S. Attorney for the Southern District of New York brought insider trading charges against two hedge fund portfolio managers, Todd Newman (formerly at now-defunct Diamondback Capital Management, LLC) and Anthony Chiasson (formerly at now-defunct Level Global Investors, LP).[3] At trial, the government provided evidence that Newman and Chiasson each traded shares of Dell and NVIDIA for their funds based upon information regarding earnings announcements that were not yet public.[4] The government showed that the corporate insiders tipped a group of research analysts, who passed along the information within the group until it was ultimately provided to Newman and Chiasson. In turn, the defendants each traded on the information resulting in profits of $4 million and $68 million, respectively, for their funds.[5]

At the close of the six-week trial, Newman and Chiasson moved for a judgment of acquittal arguing, *inter alia*, that the government failed to put forth sufficient evidence to establish that the corporate insiders exchanged confidential information for a personal benefit as required by the U.S. Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983).[6] Because the government failed to prove receipt of a benefit and tippee liability is derivative of the tipper's liability, Newman and Chiasson argued that they could not be convicted. They further argued that they could not be found guilty of insider trading, because they had no knowledge of the personal benefit to the corporate insiders, and therefore "were not aware of, or participants in, the tippers' fraudulent breaches of fiduciary duties to Dell or NVIDIA."[7]

On December 17, 2012, the jury returned a verdict finding Newman and Chiasson guilty on all ten counts of securities fraud and conspiracy to commit securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Following their sentencing, Newman and Chiasson appealed challenging, among other things, the instructions to the jury as failing to require that Newman and Chiasson had knowledge that the corporate insiders received a personal benefit in exchange for providing confidential information, and the sufficiency of the evidence relating to their knowledge of the corporate insiders' personal benefit.[8]

The Second Circuit's Decision. On appeal, the government argued that it need not show that either defendant knew that the corporate insiders received a personal benefit to be found criminally liable.[9] Instead, the government argued that, according to *Dirks* and certain cases decided by the Second Circuit after *Dirks*, criminal liability for insider trading only requires that the "tippee know that the tipper disclosed information in breach of a duty of confidentiality."[10]

The Second Circuit, however, rejected the government's argument as being inconsistent with *Dirks* and cases following it on three points that are "quite clear":

- "[T]he tippee's liability derives *only* from the tipper's breach of a fiduciary duty, not from trading on material, non-public information;"
- "[T]he corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure;" and
- "[E]ven in the presence of a tipper's breach, a tippee is liable only if he knows or should have known of the breach."[11]

The Second Circuit also rejected the government's evidence, even when viewed in the light most favorable to it, because the evidence "was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips."[12] This holding is significant because it limits an element of insider trading that many courts at the government's urging for over a

1 773 F.3d 438 (2d Cir. 2014).
2 *Id.* at 452-53.
3 *Id.* at 442.
4 *Id.* at 443.
5 *Id.*
6 *Id.* at 444.
7 *Id.*
8 *Id.* at 445.
9 *Id.* at 447.
10 *Id.*
11 *Id.*
12 *Id.* at 451-52.

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generation have viewed broadly to include personal relationships, pecuniary gains, and even "any reputational benefit that will translate into future earnings." The Second Circuit emphasized this limitation noting that holding otherwise would mean that "practically anything would qualify."[13]

As a result, the Second Circuit made clear that in order to prove a personal benefit in the context of a personal relationship, the government must show a *quid pro quo* relationship or provide "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[14]

Post-*Newman* Decisions and Enforcement Activity

Ultimately, the *Newman* decision was a stern rebuke of the government's aggressive insider trading prosecutions, which have been based upon unreasonably expansive interpretations of insider trading law that are inconsistent with *Dirks* and *Chiarella v. United States*, 445 U.S. 222 (1980).[15] Since the Second Circuit decided *Newman*, the U.S. Attorney's Office for the Southern District of New York has claimed in a letter requesting dismissal of insider trading charges against remote tippees in the proceeding captioned ***United States v. Conradt*** that *Newman* had "substantially changed the law pertaining to insider trading," even though the parameters of insider trading were made plain by Supreme Court precedent. Meanwhile dozens of defendants have sought to use *Newman* to dismiss insider trading charges, vacate their convictions, or reduce penalties. And, for the most part, courts around the country have followed *Newman* and applied it to various insider trading cases—regardless of whether the case was premised on the classical or misappropriation theory[16] or whether it was brought in federal[17] or administrative court.[18]

Despite the clear instructions from the Second Circuit, the SEC has maintained that *Newman* will not alter its approach to similar cases because the SEC still faces a lower burden of proof than criminal prosecutors and may bring insider trading cases in its own administrative courts,[19] which it has already begun to do with increasing frequency and to the consternation of many. Meanwhile, a few courts have loosely interpreted *Newman* to issue what appear to be goal-oriented decisions, which have created some uncertainty about what the government must prove in an insider trading prosecution.

For example, on March 3, 2015, Southern District of New York Judge Valerie Caproni in ***United States v. Riley*** declined to reverse the insider trading conviction of David Riley finding that he provided tips about his company in exchange for "three concrete personal benefits that were 'objective, consequential, and represent[ed] at least a potential gain of pecuniary or similarly valuable nature.'"[20] Although Judge Caproni noted that the court's

13 *Id.*

14 *Id.*

15 The government's criminal case against Newman and Chiasson suffered from similar flaws that contributed to its loss in the criminal insider trading prosecution of Rengan Rajaratnam, as well as the SEC's losses in eleven insider trading cases or claims in 2014 in which the SEC stretched the law and/or facts beyond fairness and reason. *See* Marc D. Powers, Jonathan A. Forman, and Margaret E. Hirce, *A Call for Better SEC Accountability Before Bringing Insider Trading Cases*, Bloomberg BNA, Securities Regulation & Law Report, 46 SRLR 2214 (Nov. 17, 2014).

16 Order, *United States v. Conradt*, No. 12-CR-887 (ALC), at *2 (S.D.N.Y. Jan. 22, 2015) (applying *Newman* to vacate defendants' guilty pleas and finding that: "Specifically, this Court finds that, as indicated in *Newman*, the controlling rule of law in the Second Circuit is that 'the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory.'") (internal citations omitted).

17 Opinion & Order, *SEC v. Payton*, No. 14-CV-04644-JSR, at *9-10 (S.D.N.Y. Apr. 6, 2015) ("[T]he Second Circuit, in *Newman*, stated unequivocally that '[t]he elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory.' …. these statements seem so clearly intended to give guidance to the lower courts of this Circuit that this Court takes them as binding.").

18 *In the Matter of Gregory T. Bolan and Joseph C. Ruggieri*, Order, SEC Admin. Proc. Rel. No. 2309 (Feb. 12, 2015) ("'While our case law at times emphasizes language from *Dirks* indicating that the tipper's gain need not be *immediately* pecuniary, it does not erode the fundamental insight that, in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence.'") (quoting *Newman*, 773 F.3d at 452, with emphasis in original).

19 *See* Stephanie Russell-Kraft, *SEC's Ceresney Isn't Sweating 2nd Circ.'s Newman Ruling*, Law360 (Feb. 10, 2015).

20 Opinion & Order, *United States v. Riley*, No. 13-CR-339-1, at *10 (VEC) (S.D.N.Y. Mar. 3, 2015) (quoting *Newman*, 773 F.3d at 452 with edits in original).

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instructions would have been different following *Newman*, the court ruled that the relationship was "clearly a *quid pro quo* relationship" because Riley received (i) help with his side business in the form of industry connections, (ii) investment advice in the form of stock tips, and (iii) assistance with securing his next job.[21]

Then, on April 6, 2015, Southern District Judge Jed S. Rakoff in ***SEC v. Payton*** denied Daryl M. Payton and Benjamin Durant, III's motion to dismiss where the defendants' guilty pleas previously were vacated in light of *Newman*.[22] Although Judge Rakoff claimed to apply *Newman*, the court quoted ***Riley*** for support that: "If a tip maintains or furthers a friendship, and is not simply incidental to the friendship, that is circumstantial evidence that the friendship is a quid pro quo relationship."[23] Given what appears to be a goal-oriented decision, the court found that the SEC adequately pleaded a personal benefit where it alleged that the tipper and tippee "shared a close mutually dependent financial relationship" as evidenced by a "history of personal favors" in which the tippee "pa[id] their shared expenses," negotiated reductions in their utilities and rent payments," and helped the tipper defend against an unrelated criminal matter.[24] The court also explained that, in contrast with the defendants in *Newman* who "knew next to nothing" about the tippers, the SEC alleged that "the defendants knew the basic circumstances surrounding the tip."[25] The court noted that it may draw an adverse inference against the defendants due to their knowledge, "their market sophistication," and the apparent facts that they "recklessly avoided discovering additional details" and they "took multiple steps to conceal their own trading."[26] However, such an inference does seem to stretch the facts, which objectively are not consistent with *Newman*'s personal benefit requirement.

Similarly, Administrative Law Judge Jason S. Patil in the administrative proceeding ***In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri*** applied *Newman* but deferred ruling on motions for summary disposition, noting: "Although mere friendship, particularly of a casual or social nature, will not be enough for the Division to prevail with respect to Trader A, it is in my mind an open question whether and what sort of friendship may satisfy the personal benefit element in this matter."[27]

Because the evidence of a personal benefit in *Riley* and *Payton* is similar to the evidence in *Newman*, which the Second Circuit found to be insufficient, these decisions appear to be inconsistent with *Newman*. *Bolan* also appears to conflict with *Newman* because the Second Circuit in *Newman* required more than a showing of friendship to establish a personal benefit. By allowing a prosecution to proceed on such bare-bone allegations of a personal benefit supported by a close friendship, *Bolan* skirts *Newman*'s mandate.

Compliance Takeaways

Notwithstanding the uncertainty presented by these cases and the possibility that the government may still seek Supreme Court review of the Second Circuit's decision, *Newman* provides guidelines on which compliance personnel can rely in updating their insider trading policies and procedures. In particular, this can be done in at least five significant ways:

- **First**, to be guilty of insider trading, you must know the information received is non-public. In this sense, it seems appropriate, and not a violation of the federal securities laws, to engage in a stock trade in a company where information about the company is learned from a friend or colleague who is unaffiliated with the company and there is no reason to believe that the information came from someone at the company who is in a breach of a duty of confidentiality (or other fiduciary duty).
- **Second**, to be guilty of insider trading, the information must be material and not the kind of information that merely fills in the gaps.[28] In this sense, it also seems appropriate, and not a violation of the federal securities laws, to use public information (e.g., observing parking lots of retail stores) to flesh out or confirm investment hypotheses and/or assumptions—indeed, that is precisely what analysts are supposed to do.
- **Third**, it is worth highlighting that *Newman*'s boundaries are far from bright lines, particularly in light of the decisions in *Riley*, *Payton*, and *Bolan*. Given this, there is no guarantee that the government will refrain from investigating, charging, and possibly obtaining an insider trading conviction from a jury on conduct they believe to be unlawful even when it is completely legal.
- **Fourth**, *Newman* in no way opens up the floodgates to indiscriminate trading on possible inside information. To the contrary, it clarifies what conduct is prohibited. Moreover, significant incentives for individuals toeing the line still exist outside and apart from any governmental prosecutions. For example, individuals (whether they be corporate insiders or other tippees) may be fired for breaching an employment agreement or fiduciary duty, sued by an employer or third party for breaching a confidentiality agreement, or face other stiff consequences for cavalier activity.
- **Fifth**, firms should monitor their analysts and traders for conduct suggesting questionable and/or unlawful activity and test their investment hypotheses to verify, among other things, whether a proposed trade is based on information learned in violation of a fiduciary duty. For example, is the information the type that only corporate insiders would generally be aware of at the time? Have there been any lifestyle changes by the analyst or trader? Is the analyst or trader using private cell phones and/or texts at unusual times? Does the analyst or trader have undocumented contact with particular corporate insiders? The list goes on.

So while hedge funds, investment banks, and other money managers can sleep better at night knowing that they are less likely to be caught in the government's prosecutorial dragnet (based on, for example, a casual conversation one of their analysts may have with a former classmate or other acquaintance), they should still take appropriate measures to protect themselves. This may even mean abstaining on an otherwise innocent trade when the surrounding facts and circumstances are questionable and might pique the government's curiosity. After all, despite *Dirks*, *Chiarella* and *Newman*, insider trading undoubtedly will continue to be a priority for the government, which has shown an increasing interest in money managers in recent years. ✦

21 *Riley* at *10-15.
22 *Payton* at *16.
23 *Payton* at *13.
24 *Payton* at *4.
25 *Payton* at *14-15.
26 *Payton* at *15.
27 *In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri*, Order on Motions for Summary Disposition, SEC Admin. Proc. Rel. No. 2350, at *2 (Feb. 25, 2015).

28 The "mosaic theory"—wherein analysts piece "seemingly inconsequential data together with public information into a mosaic which reveals material non-public information"—has long been viewed as a defense to an insider trading charge. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980); *see also State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981).

Secondary Trading in JOBS Act Securities

By Richard Chase and Shannon Fitzgerald

I. Background

The Jumpstart our Business Startups – or JOBS – Act[1] has opened up new opportunities for emerging companies to raise capital through primary offerings. Title III of the JOBS Act establishes an entirely new offering format – called "crowdfunding" – for new entrepreneurs seeking to raise relatively small amounts of capital, while Title IV directs the U.S. Securities and Exchange Commission (the "SEC") to adopt rules to broaden the size and availability of an existing registration exemption. In late March 2015, the SEC adopted final rules to implement this Title IV directive. This article describes Titles III and IV of the JOBS Act, and discusses opportunities, and challenges, in integrating these vehicles for issuers to raise capital through primary offerings into the secondary trading markets.

The JOBS Act is a striking, even startling, piece of legislation. In response to the 2008 financial crisis, which was arguably the most significant U.S. and global economic upheaval since the Great Depression, the Congress in 2010 enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2]. Over 2200 pages long, and requiring regulatory agencies to adopt literally hundreds of new rules, Dodd-Frank has imposed new requirements and mandated rigorous new regulations that touch on virtually all elements of the financial markets. By contrast, enacted just two years later, the JOBS Act is profoundly de-regulatory. It is intended to exempt emerging growth companies from registration obligations and unshackle financial firms from restrictions that could hinder their support of those companies' financing efforts.

How did this turnabout occur? The seeds were seemingly planted in the year after Dodd-Frank was enacted. In a March 22, 2011 letter from Cong. Darrell Issa to former SEC Chair Mary Schapiro, Cong. Issa raised deep concerns about the impact of U.S. securities regulations on capital formation in the U.S., especially for early stage companies, and cited a number of disturbing trends. The letter began by noting that the number of initial public offerings ("IPOs") in the U.S. declined from an annual average of 530 during the 1990's to 126 per year since 2001, with only 38 IPOs in all of 2008 and 61 in 2009. As a result, the overall number of exchange-listed companies in the U.S. fell from over 7000 at its peak to about 4000 in 2011 (a number that has continued to fall). Cong. Issa further surmised that foreign issuers have come to shun the U.S. markets. According to Cong. Issa, U.S. exchanges were once globally dominant, capturing 77.3% of global foreign issuer IPOs in 1996. By 2008, however, the U.S. exchange market share of these foreign issues was just 1.9%. Conversely, U.S. issuers who chose to list solely on foreign exchanges, once virtually unheard of, increased from 0.3% in the period from 1996-2002 to 8.6% in 2007 and 20% in 2008. Cong. Issa concluded his letter by requesting responses from the SEC on 32 detailed questions, including several questions related to early stage capital formation.

Over the course of the next year, concerns regarding regulatory burdens on entrepreneurship and small business capital formation grew in Congress on both sides of the aisle. In response, several bills were introduced in both the House and the Senate beginning in late 2011, including the JOBS Act, which was introduced in March 2012. The JOBS Act, in particular, captured strong bi-partisan support, and was quickly endorsed and signed into law by President Obama.

Support, however, was not universal. In a letter to the Senate Banking Committee sent the week before the JOBS Act's enactment, SEC Chair Schapiro expressed serious reservations about the law, warning, "Too often, investors are the target of fraudulent schemes disguised as investment opportunities. . . . [I]f the balance is tipped to the point where investors are not confident there are appropriate protections, investors will lose confidence in our markets, and capital formation will be made more difficult and expensive."[3] SEC Chair Schapiro opined that the crowdfunding provisions of the law, in particular, needed "additional safeguards."[4]

These reservations on the part of the SEC, the regulator charged with implementing and enforcing the JOBS Act, have had significant consequences, both on the content of the law and on its subsequent implementation by the SEC and use by the industry. One noteworthy impact has been a failure to completely integrate the capital raising provisions of the JOBS Act into the entire fabric of the securities laws, which cover not just initial distributions of securities, but their trading in the aftermarket as well. In the following sections, we discuss the principal capital raising provisions of the JOBS Act, namely, Title III (crowdfunding) and Title IV (Regulation A+), and how those provisions tie in to the overall securities market structure.

II. Title III – Crowdfunding

A. Registration and Central Clearing

In addition to providing a mechanism for the initial distribution (underwriting) of securities, the architecture surrounding the public securities markets involves centralized research, transaction hubs, the consolidated tape, the Depository Trust & Clearing Corporation (the "DTCC"), and several other tightly integrated points of integrity.[5] By contrast, beyond the initial placement of securities with investors, the online private securities market presently lacks a robust organizational and support infrastructure.[6] With respect to crowdfunded equities and peer-to-peer ("P2P")[7] debt, there is no

1 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 David S. Hilzenrath, *JOBS Act Could Remove Investor Protection SEC Chair Schapiro Warns*, Wash. Post (Mar. 14, 2012), http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html.

4 *Id.*

5 Matt Dellorso, *The Promise – And Challenges – Of Equity Crowdfunding*, Forbes (June 25, 2014, 9:13AM), http://www.forbes.com/sites/groupthink/2014/06/25/the-promise-and-challenges-of-equity-crowdfunding/.

6 John Kuo, *Equity Crowdfunding Is Now Legal. How Can You Get Your Piece of the Action?*, Nerdwallet (Sept. 25, 2013), http://www.nerdwallet.com/blog/investing/2013/equity-crowdfunding-legal-piece-action/.

7 Peer-to-peer lending is the practice of lending money to unrelated individuals, or "peers," without going through a traditional financial intermediary such as a bank.

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central data repository to store and manage position and transaction data related to these asset classes, nor facilities or processes for the efficient clearance and settlement of resales (secondary market transactions). Lacking such a repository, and since these securities are restricted, it is difficult for funding portals[8] or brokers to determine what individual investors have invested during the previous 12-month period.[9] As it stands, investors have typically been required to self-certify their compliance with the investment limitations of these securities.[10]

The best way to assure actual compliance with the resale restrictions of crowdfunded equities and P2P loans would be to form a central data repository.[11] Data on participating investors could be provided by an intermediary to a clearinghouse after each successful issue. Such a clearinghouse could also be used to maintain data, including each investor's net worth and annual income, as well as certifications that they have completed their investor education requirements.[12] This would enable investors to provide such information annually to the clearinghouse rather than to each funding portal for every investment made. Logical choices for operating such a clearinghouse include the SEC, FINRA or the DTCC, or a private body such as Dealogic.[13]

The DTCC already provides a central data repository for other types of unregistered securities, as well as maintains a clearance and settlement program for alternative investment products. As such, it is the fastest, easiest and most cost-effective solution to implementing a crowdfunding clearinghouse. There is no indication that issuers, intermediaries or regulatory authorities have approached the DTCC to organize or operate such a facility, however. Likewise, there is no evidence that the DTCC has affirmatively offered its central data repository or post-trade services to crowdfunding issuers. Nevertheless, nothing in Title III of the JOBS Act prohibits crowdfinanced assets from being accepted by the DTCC.[14] It thus remains feasible that the DTCC could seek to register crowdfunded securities as a secondary market for this asset class evolves.[15]

B. Secondary Market Trading

Since crowdfunded securities are restricted, there will be very limited (if any) secondary trading activity during the first year following their issuance.[16] Furthermore, under Title III of the JOBS Act, the most that can be raised in a crowdfunding offering is $1 million.[17] That may not constitute a sufficient public float to pass muster for secondary trading for many issuers. It is, therefore, critical to the establishment of a successful secondary trading market that issuers' market values rise above this threshold once they have sufficient seasoning to trade on an unrestricted basis. Secondary trading markets have begun to emerge for crowdfinanced assets, but they are still in the "embryonic stage."[18] For P2P debt in particular, investors should expect to hold their loans to maturity (typically, 36 to 60 months).[19]

C. Funding Portals and Settlement Risk

Folio Institutional[20] is one funding portal that appears to be leading the way with respect to conducting post-trading activities for crowdfinanced products. Unless and until a central clearinghouse emerges, however, it is essential that all funding portals be able to clear and settle securities transactions executed on their respective platforms. It is further critical that all funding portals are able to temporarily gain control of funds once the obligations have become final, in order to clear and settle transactions.[21] This will ensure safe, efficient and effective clearance and settlement throughout the market.[22]

Similarly, in order to clear and settle an initial offering, as well as to facilitate secondary trading, it may be advisable for funding portals to operate book-entry systems in which dematerialized securities are held.[23] In order to maintain a simple shareholder structure for companies that raise capital through a crowdfunding offering, funding portals should also be able to serve as a single shareholder (or holder of record) for purposes of an issuer's register/shareholder structure.[24] This can be easily accomplished via the book-entry system. As is currently the case in many crowdfunding transactions outside of the U.S., funding portals would then communicate with the individual shareholders (or beneficial holders of shares).[25]

Capital requirements represent one major regulatory difference between equity and debt-based crowdfunding platforms.[26] Unlike

8 A funding portal is any person acting as an intermediary in a crowdfunding transaction that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales or offers to buy the securities displayed on its platform or portal (iii) compensate employees, agents or other persons for such solicitation or the sale of securities; or (iv) hold, manage, process or otherwise handle investor funds. Funding portals that engage in crowdfunding on behalf of issuers relying on the JOBS Act's "crowdfunding exemption" must register with the SEC and become a member of a national securities association. See James M. Harrigan, *FINRA Proposes Funding Portal Rules under the JOBS Act*, O'Melveny & Myers LLP (Nov. 11, 2013), http://www.omm.com/finra-proposes-funding-portal-rules-under-the-jobs-act-11-11-2013/. See also FINRA Regulatory Notice 13-34 (Oct.2013), http://www.finra.org/sites/default/files/NoticeDocument/p370743.pdf (FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms) for more information on funding portals.

9 *See* letter from Neal C. McCane, risingtidefunding.com, to SEC, (Sept. 26, 2012), at 2, https://www.sec.gov/comments/jobs-title-iii/jobstitleiii-158.pdf.

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.* at 3. Dealogic, a private company, operates a repository that warehouses certifications made by broker-dealers, banks and investors representing that they are "qualified institutional buyers" or "QIBs" under SEC Rule 144A. An investor that participates in numerous 144A offerings is thereby able to submit a single QIB certification to Dealogic, rather than having to submit separate certifications for each transaction. *See also* Dealogic, http://www.dealogic.com/ (last visited May 28, 2015).

14 *See* Securities Act Release No. 33-9470 (Oct. 23, 2013), 78 FR 66427 (Nov. 5, 2013), https://www.sec.gov/rules/proposed/2013/33-9470.pdf.

15 CUSIP Global Services provides the CUSIP identifiers for crowdfunding offerings. Such identifiers are known as CUSIPS for Crowdfunding. They feature the same 6-character issue and 9-character issue format used for regular CUSIPs. CUSIPs for Crowdfunding are available upon request for most crowdfunding offerings with valid support documentation.

16 Under new Section 4A(e) of the Securities Act of 1933, broad restrictions on resales are imposed during the first 12 months following their initial issuance. Transfers (resales) by the original purchasers are only permitted as follows: back to the issuer, to an accredited investor, to a family member, or in a registered offering.

17 The ceiling is raised to $2 million for issuers with audited financials.

18 Dara Albright, James A. Jones and Chris Staples, *The Financial Advisor's Guide to P2P Investing*, (Apr. 13, 2015), at 13, https://daraalbright.files.wordpress.com/2015/04/the-financial-advisors-guide-to-p2pi-final.pdf.

19 *Id.*

20 *See* Folio Institutional, https://www.folioinstitutional.com/about-institutional.jsp (last visited May 28, 2015).

21 Letter from Jouko Ahvenainen, Valto Loikkanen and the Grow VC legal team, Grow VC Group, to SEC (Jun. 15, 2012), at 5, https://www.sec.gov/comments/jobs-title-iii/jobstitleiii-88.pdf.

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.*

26 Avtar Sehra PhD, *The Subtle Risks in Equity Crowdfunding the Industry is Ignoring*, Innovation Insights (Jan. 26, 2015, 10:35AM), http://insights.wired.com/profiles/blogs/the-subtle-risks-in-equity-crowdfunding-the-industry-is-ignoring#axzz3Y5KJvzUP.

debt-based platforms, capital requirements for equity platforms have not to date been a serious consideration. They generally do not manage investor money for extended periods of time,

apart from facilitating capital transfers after completion of the crowdfunding transaction lifecycle.[27] In addition, there are no ongoing cash flows to manage after an equity crowdfunding campaign ends and the initial capital transfer is made.[28] However, as the volume, size and complexity of deals grows on equity-based platforms, the turnaround time for completing transactions could be expected to increase. As a result, the length of time crowdfunding platforms end up holding client funds could increase.[29] This effect could then introduce potential settlement risks down the line, and commensurately increase the benefits of having a central repository for the custody, clearance and settlement of crowdfunded securities transactions.

D. The Future of Crowdfunding

As noted in Section II.B. above, embryonic secondary market in some crowdfunded assets has begun to emerge. In the end, however, we have serious reservations as to whether crowdfunding will ultimately turn out to be much more than an historical curiosity. To date, established banks and broker-dealers have largely avoided involvement with crowdfunding initiatives. This is undoubtedly in part a function of such small issues not being "worth the bother" for firms accustomed to dealing in transactions in the 100's of millions of dollars, not the 100's of thousands. They cannot be unmindful, however, of the SEC's firmly stated reservations regarding crowdfunded securities and the perils of fraud their abbreviated disclosures and offering procedures present. They are limited in size, launched without the imprimatur of established firms, considered suspect by their primary regulator, disconnected to the architecture of the existing public securities markets, and lack the prospect of any secondary market liquidity. Inevitably, some (perhaps most) crowdfunding ventures will prove financially unsuccessful, and some may even turn out to be far worse – a ponzi scheme or some other form of fraud or swindle. While established markets and institutions can withstand an occasional hit to their credibility, we are concerned that this array of strikes may prevent the nascent crowdfunding market from ever taking off. Time will have to tell.

III. Title IV – Regulation A+

A. Key Elements

Registration for smaller issuers of securities has historically been encumbered by Blue Sky review. This has effectively destroyed the efficacy of the original Regulation A exemption to registration available to small issuers.[30] The JOBS Act thus included a section requiring the SEC to adopt rules to implement an updated and expanded version of Regulation A, and provided an effective pre-emption of state Blue Sky regulation of certain offerings made under this expanded authority. The resulting rule amendments, often collectively referred to as Regulation A+, were issued by the SEC in mid-March and become effective on June 19, 2015.[31] The new registration exemption provided by Regulation A+ has been described as a mini-IPO, in that it allows for a cost-effective, streamlined registration process.[32] The Regulation A+ exemption is limited to companies organized in and with their principal place of business in the U.S. or Canada.[33] Crowdfunding platforms, in particular, are expected to leverage Regulation A+.[34]

Regulation A+ provides for two tiers of offerings. Tier 1 consists of securities offerings of up to $20 million in a 12-month period, with not more than $6 million in offers by selling security-holders that are affiliates of the issuer.[35] Tier 1 essentially mirrors the exemption available under current Regulation A.[36] Tier 2 consists of securities offerings of up to $50 million in a 12-month period, with not more than $15 million in offers by selling security-holders that are affiliates of the issuer.[37]

In addition to the limits on secondary sales by affiliates, the new rules limit sales by all selling security-holders to no more than 30% of a particular offering in the issuer's initial Regulation A offering, and subsequent Regulation A offerings for the first 12 months following the initial offering.[38] Further, if an issuer has (1) more than 500 unaccredited shareholders of record, or 2,000 shareholders of record, and (2) at least $10 million in assets, it will generally be required to file periodic reports with the SEC (e.g. Form 10-K's and 10-Q's).[39]

For offerings of up to $20 million, an issuer could elect to proceed under either Tier 1 or Tier 2.[40] Both tiers would be subject to basic requirements as to issuer eligibility, disclosure and other matters, drawn from the current provisions of Regulation A.[41] Both tiers would also permit issuers to submit draft offering statements for nonpublic review by SEC staff before formal public filing, permit the continued use of solicitation materials after filing the offering statement, require the electronic filing of offering materials, and otherwise align Regulation A with current practices for registered offerings.[42]

In addition to these basic requirements, issuers conducting Tier 2 offerings would be subject to additional disclosure and ongoing reporting requirements. Specifically, they would be required to: (i) provide audited financial statements; (ii) file annual, semiannual and current event reports; and (iii) limit the amount of securities non-accredited investors can purchase to no more than 10% of the

greater of the investor's annual income or net worth (excluding primary residence).[43]

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27 *Id.*
28 *Id.*
29 *Id.*
30 *JD Alois, Reg A Plus & Developing Venture Exchanges (Webinar)*, Crowdfund Insider (Mar. 16, 2015, 5:55PM), *available at* http://www.crowdfundinsider.com/2015/03/64507-reg-a-plus-developing-venture-exchanges-webinar/.
31 Securities Act Release No. 33-9741 (Mar. 25, 2015) 80 FR 21805 (Apr. 20, 2015), http://www.sec.gov/rules/final/2015/33-9741.pdf.
32 Milken Inst. Ctr. for Fin. Mkts., Summary of *Regulation A+ and the Mini-IPO – A Roundtable Discussion of Title IV of the JOBS Act*, McCarter & English, available at http://www.mccarter.com/Regulation-A-and-the-Mini-IPO--A-Roundtable-Discussion-of-Title-IV-of-the-JOBS-Act-02-10-2014/.
33 Press Release, SEC, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-49.html.
34 JD Alois, *FACT SHEET: Regulation A+, Title IV of the JOBS Act*, Crowdfund Insider (Mar. 29, 2015, 12:02PM), http://www.crowdfundinsider.com/2015/03/65172-fact-sheet-regulation-a-title-iv-of-the-jobs-act/.
35 *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital, supra* note 33.
36 Alois, *supra* note 34.
37 *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital, supra* note 33.
38 *Id.*
39 Sam Guzik, *New SEC Regulation A+: Everything You Need to Know*, Onevest Blog (Mar. 27, 2015), http://blog.onevest.com/blog/2015/3/27/new-sec-regulation-a-everything-you-need-to-know.
40 *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital, supra* note 33.
41 *Id.*
42 *Id.*
43 *Id.*

Regulation A+ exempts securities in a Tier 2 offering from the mandatory registration requirements of Exchange Act Section 12(g) if an issuer meets all of the following conditions: (i) engages services of a transfer agent registered with the SEC; (ii) remains subject to a Tier 2 reporting obligation; (iii) is current in its annual and semiannual reporting at fiscal year-end; and (iv) has a public float of less than $75 million as of the last business day of its most recently completed semiannual period, or, in the absence of a public float, had annual revenues of less than $50 million as of its most recently completed fiscal year.[44]

Tier 1 offerings remain subject to state registration and qualification requirements, and issuers may take advantage of the coordinated review program developed by the North American Securities Administrators Association (NASAA).[45] However, the new rules provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to "qualified purchasers," which are defined as any persons to whom securities are offered or sold under a Tier 2 offering.[46]

B. Implications

a. Positive Impacts

By making it easier for small and medium-sized companies to issue securities without meeting full-blown SEC registration requirements, while creating greater transparency and openness in the market for such securities, Regulation A+ may serve as an important catalyst for increased capital raising by such companies, and thereby contribute to overall growth for the U.S. economy.[47] Securities sold pursuant to Regulation A+ will not be restricted securities and may be immediately resold. Regulation A+ securities may be offered and sold publicly, so long as the securities are offered or sold on a national securities exchange, or offered or sold to qualified purchasers.[48]

Regulation A+ will require the filing of an offering circular with the SEC, but this disclosure will be far less onerous and expensive than the disclosures required in a conventional registration statement for a traditional IPO.[49] An issuer will also be permitted to "test the waters," and solicit interest in its securities before filing the offering circular.[50] This will allow issuers to gauge interest in the securities before bearing the expense of complying with Regulation A+.[51] Furthermore, while the upfront information delivery requirements may be more burdensome than in crowdfunding, issuers would be able to raise far larger dollar amounts without concern for individual investment caps.[52]

Regulation A+ is a step in the right direction, and may be a viable alternative to the mid- to late-stage funding rounds.[53] Additionally, compliance with Regulation A+'s offering circular, financial and other disclosure requirements may be considered a dress rehearsal for a full-blown registered public offering for later-stage companies.[54] Nevertheless, Regulation A+ also presents some challenges.

b. Limitations

Since Tier 1 offerings are not exempt from Blue Sky filings, Tier 1 issuers will need to file documentation with each state in which they plan to raise capital. Although Tier 2 offerings are exempt from Blue Sky filings, Tier 2 issuers are subject to ongoing reporting requirements in perpetuity (i.e., either until they go public or fail).[55] Specifically, issuers must make semi-annual and annual filings with the SEC that include audited financial statements for the two most recent years, along with narrative disclosures. This effectively subjects private companies to many of the same regulatory burdens carried by public companies.[56]

While the SEC did include a provision in Regulation A+ that allows issuers to validate investor demand prior to preparing full-blown offering circulars, this process will still be more expensive and time consuming than filing a Form D, which is the only comparable requirement in Regulation D offerings.[57] Given the opportunity to raise an uncapped amount of capital under Rule 506 of Regulation D with limited SEC reporting requirements, it is then possible that Regulation A+ may not enjoy much more popularity than Regulation A.[58]

At the very least, early adoption of Regulation A+ by startup companies appears to be unlikely.[59] Access to capital via private

44 *Id.*
45 *Id.*
46 *Id.*
47 *See* Press Release, Allegiancy, Allegiancy CEO Steve Sadler to Speak About Potential of New Regulation A+ Rules at Upcoming Securities Conferences (Sept. 22, 2014), *available at* http://www.allegiancy.us/press-release/allegiancy-ceo-steve-sadler-speak-potential-new-regulation-rules-upcoming-securities-conferences.
48 Paul Bork and Dean F. Hanley, *JOBS Act – Small Company Capital Formation – Regulation A+*, Foley Hoag LLP (Apr. 24, 2012), http://www.foleyhoag.com/publications/alerts-and-updates/2012/april/jobs-act-small-company-capital-formation-regulation-a.
49 *Id.*
50 *Id.*
51 *Id.*
52 Corporate Advisory, *"Private" Capital-Raising Under the JOBS Act*, Sullivan & Worcester LLP (Jul. 2012), *available at* http://www.sandw.com/assets/htmldocuments/CLIENT%20ADV.%20-%20Private%20Capital-Raising%20Under%20the%20JOBS%20Act%20B1451937.PDF.
53 Shri Bhashyam, *Regulatory Alert: Regulation A+ and What It Means For Startups*, EquityZen Blog (Mar. 27, 2015), https://equityzen.com/blog/regulation-a-plus-what-it-means-for-startups/. Indeed, at least some commentators have suggested that Regulation A+ effectively obviates the need for further implementation of Title III of the JOBS Act. See Michael Raneri, *Who Needs Equity Crowdfunding? 3 Critical Questions about Title III of the JOBS Act*, Forbes (Apr. 16, 2015, 4:30PM), http://www.forbes.com/sites/mraneri/2015/04/16/who-needs-equity-crowdfunding-3-critical-questions-about-title-iii-of-the-jobs-act/. (Some commentators view definition of Title III – crowdfunding – rules by the SEC as the logical next step in a steady, if slow, progress toward full implementation of the JOBS Act. Others expect the SEC to wait and see, in particular with regard to how the newly defined Title IV rules will be put into use, before making any progress on new crowdfunding rules.)
54 *JOBS Act – Small Company Capital Formation – Regulation A+, supra* note 48.
55 Rory Eakin, *The JOBS Act is Progress But Much Remains To Be Done*, TechCrunch (Mar. 29, 2015), http://techcrunch.com/2015/03/29/the-jobs-act-is-progress-but-much-remains-to-be-done/.
56 *Id.*
57 *Id.*
58 *"Private" Capital-Raising Under the JOBS Act, supra* note 52.
59 Bhashyam, *supra* note 53.

markets is currently plentiful across the growth stages.[60] At the early stage, new micro venture capitalists and seed funds pop up regularly, and raising a seed round is far easier today than in years past. Further, the time and monetary costs associated with Regulation A+ offerings may not make sense for the amount of capital raised at seed or Series A rounds of investments. At later stages, capital also proliferates, especially with mutual and hedge funds increasingly investing in the late- and/or growth-stage, with numerous reports of start-ups successfully raising from $50 million to $500 million or more in multiple rounds of financing.[61] This capital is available at favorable valuations, so unless that "spigot" dries up, there may not be much incentive to be an early adopter of Regulation A+, with its funding limits of $20-50 million and attendant regulatory financial and reporting requirements.[62]

c. Exchange Trading and Venture Capital Exchanges

Regulation A+ aims to do a lot of things, but it only scratches the surface with respect to aftermarket support issues. The SEC received a broad spectrum of views from commentators on secondary trading issues under Regulation A+, from commentators urging a ban on resales by non-affiliates as well as affiliates, to commentators urging the SEC to foster the creation of venture exchanges specifically to facilitate secondary trading.[63] In the release adopting Regulation A+, the SEC recognized that "allowing selling security holders access to avenues for liquidity will encourage them to invest in [Regulation A+] companies."[64] In the final rules, the SEC took limited steps to facilitate exchange registration of Regulation A+ securities. The SEC permits an issuer seeking exchange registration of Tier 2 Regulation A+ securities to register them on Form 8-A, which is somewhat less onerous than full Form 10 registration, so long as the exchange registration is undertaken concurrently with the issuer's qualification of the securities under Regulation A+ (or concurrently with re-qualification of previously qualified securities). The SEC notes that this approach results in more extensive reporting obligations on the issuer than the Regulation A disclosure regime alone, but concluded that this additional disclosure would benefit investors.[65]

To date, the SEC has been unwilling to adopt further measures that might facilitate exchange trading of Regulation A+ securities. For example, in explaining its decision to permit exchange trading, the SEC made reference to the benefit to investors of such issues needing to comply with the qualitative and quantitative requirements of exchange initial and continuing listing standards, including size, financial, minimum distribution and corporate governance criteria.[66] This suggests that the SEC may be reluctant, until it has gained some favorable experience under the new rules, to consider proposals to relax those listing standards to accommodate Regulation A+ issuers. In a similar vein, some commentators have urged the SEC to consider allowing or facilitating the development of venture capital exchanges. In response, the SEC stated that it was "considering" the idea of venture exchanges and "contemplating" their use for Regulation A+ securities.

This is consistent with the incremental approach the SEC has taken more broadly with respect to market structure issues, particularly for smaller issuers and lower priced securities.[67] The SEC's recently adopted tick size pilot, for example, is intended to test quotation and trading increments and other structural issues (possible "trade at" requirements) for several broad test groups of securities in the near term. We applaud SEC Chair Mary Jo White's willingness to tackle complex market structure issues, and support measures such as the modest relief provided in Regulation A+ and the tick size pilot. Ultimately, however, given the breadth and pace of change in our rapidly evolving securities trading markets, we believe there needs to be a more focused and holistic approach taken to address the need for secondary market liquidity. ✦

60 In Cong. Issa's letter to SEC Chair Schapiro, he noted that, from 2009 to 2011, transactions in private shares almost tripled from $2.4 billion to $6.9 billion, and private funding has skyrocketed since then. In the six months from June to December 2014, just one private issuer, Uber, was able to raise more than $2 billion in private funding, and as of in May 2015, was in discussions to raise $1.5 billion more. See Mike Isaac and Michael J. de la Merced, Investments in *Start-Ups Pick up Pace*, N.Y. Times (May 11, 2015) at B1, available at http://www.nytimes.com/2015/05/11/technology/uber-valuation-highlights-the-speedy-pace-of-investments.html.

61 Bhashyam, *supra* note 53.

62 *Id.*

63 *See* Securities Act Release No. 33-9741 (Mar. 25, 2015), 80 FR 21805 (Apr. 20, 2015), pp. 33-34.

64 *Id.* at 33.

65 *Id.* at 191.

66 *Id.*

67 Public Statement, *Opening Remarks at Meeting of SEC Advisory Committee on Small and Emerging Companies*, Statement by SEC Chair Mary Jo White (Mar. 4, 2015), *available at* http://www.sec.gov/news/statement/opening-remarks-to-acsec.html.

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Social Media – Compliance Risk Management Considerations

By Tina Mitchell

New technologies and social media outlets are everywhere you turn. A report issued in November 2014 by the U.S. Department of Commerce Economics and Statistics Administration (US Census Bureau)[1] outlined that:

"In 2013, 83.8 percent of U.S. households reported computer ownership, with 78.5 percent of all households having a desktop or laptop computer, and 63.6 percent having a handheld computer."

In the financial industry, more and more investment advisory and broker-dealer firms are utilizing technology, including the use of social media for business advertising and client communications. This is being employed in a number of ways, including through use of:

- Websites for business promotion;
- Blogs, microblogs, and bulletin boards for distribution of experiences, ideas and observations;
- Networking sites to connect and exchange ideas with other professionals in the industry;
- Client portals to provide clients with access to account information and documents; and
- Video and presentation posting sites for providing financial advice and investment educational information

In this article, we discuss the ongoing regulatory concerns of the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA") regarding the industry's use of social media, and provide practical risk management tips for investment advisers and broker-dealers to help ensure proper oversight and controls pertaining to the applicable risks in this area.

Regulatory Considerations

FINRA and the SEC have issued numerous risk alerts to registered firms and provided guidance to investors pertaining to the use of social media in the financial industry. Their continued concerns surround not only the potential for financial firms to harm investors through this venue, but also the potential of a firm's lack of adherence to applicable regulations, particularly in the areas of marketing and advertising, solicitation activities, safeguarding non-public information, books and records retention, anti-money laundering, custody and cybersecurity.

Below is a timeline of some of the more notable steps taken by the SEC and FINRA in the last five years via alerts, disciplinary cases and written bulletins that publicize regulatory issues and concerns surrounding social media.

1 U.S. Computer and Internet Access in the United States: 2013, American Community Survey Reports (November 2014) at http://www.census.gov/content/dam/Census/library/publications/2014/acs/acs-28.pdf.

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SEC Actions

January 2012 – Division of Enforcement issued a cease and desist order against a registered investment adviser who they alleged had violated a number of federal securities laws by, among other things, making multiple fraudulent offers of fictitious securities through various forms of social media and disseminating materially false and misleading information via firm websites.[2]

Simultaneous to the issuance of the press release regarding that case, the SEC Office of Compliance Inspections and Examinations ("OCIE") issued a National Exam Risk Alert to investment advisers providing guidance on their use of social media,[3] and the SEC Office of Investor Education and Advocacy ("OIEA") published an Investor Alert and Investor Bulletin to assist investors in avoiding investment fraud on the internet.[4]

May 2012 – OIEA published an Investor Bulletin to help senior investors who use the internet on avoiding investment fraud.[5]

March 2013 - Division of Investment Management issued written guidance to registered investment companies on their obligation for filing certain interactive data.[6]

March 2014 – Division of Investment Management issued written guidance to investment advisory firms on the testimonial rule and use of social media.[7]

July 2014 – OIEA issued an Investor Alert on stock rumors communicated through social media.[8]

November 2014 - OEIA updated and reissued its 2012 Investor Alert on avoiding investment fraud.[9]

2 In the matter of Anthony Fields, CPA d/b/a/ Anthony Fields & Associates and d/b/a Platinum Securities Brokers (IA Release No. 3348, Jan. 4, 2012.

3 National Exam Risk Alert (Jan. 4, 2012) at http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

4 SEC Investor Alert – Social Media and Investing – Avoiding Fraud (Jan. 4, 2012) at http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf. See also SEC Investor Bulletin – Social Media and Investing – Understanding Your Accounts (Jan. 4, 2012) at http://www.sec.gov/investor/alerts/socialmediaandinvesting.pdf.

5 SEC Investor Bulletin – Social Media and Investing – Tips for Seniors (May 1, 2012) at http://investor.gov/news-alerts/investor-bulletins/social-media-investing-tips-seniors.

6 SEC Division of Investment Management IM Guidance Update #2013-01 (Mar. 2013) found at http://www.sec.gov/divisions/investment/guidance/im-guidance-update-filing-requirements-for-certain-electronic-communications.pdf.

7 SEC Division of Investment Management IM Guidance Update #2014-04 (Mar. 2014) found at http://www.sec.gov/investment/im-guidance-2014-04.pdf.

8 SEC Investor Alert – Social Media and Investing – Stock Rumors (Jul. 25, 2014) at http://www.sec.gov/oiea/investor-alerts-bulletins/ia_rumors.html.

9 SEC Updated Investor Alert – Social Media and Investing – Avoiding Fraud (Nov. 12, 2014) at http://www.sec.gov/oiea/investor-alerts-bulletins/ia_socialmediafraud.html.

FINRA Actions

January 2010 – FINRA issued written guidance on a firm's use of blogs and social media websites.[10]

July 2010 – FINRA issued an alert to investors on social media-linked Ponzi schemes in regards to high-yield investment programs.[11]

February 2011 - FINRA listed electronic communications and social media use as issues of heighten regulatory importance in its annual exam priorities letter.[12]

January 2012 - FINRA again listed electronic communications and social media use as issues of heighten regulatory importance in its annual exam priorities letter.[13]

June 2013 - FINRA performed a sweep exam on broker-dealer social media communications,[14] which included, but was not limited to a review of a firm's top 20 producers based on commissions who used social media for communicating with investors, and the firm's current written supervisory procedures covering social media communications.

April 2015 - FINRA issued a disciplinary action and fine against a research analyst who failed to disclose his ownership of securities he was discussing via social media.[15]

Also available on FINRA's website at www.finra.org are a number of electronic courses (E-Learning) and pod casts, which cover social media.

Risk Management Controls

The risks surrounding the use of social media by financial firms can vary considerably and are dependent on, among other things, the type and extent of a firm's social media use. Investment advisers and broker-dealers using social media should have risk management controls that are customized and equivalent to their usage, and constructed to prevent investor harm. That being said, there are important core protocols that apply to all firms using social media. These include:

- Having written policies and procedures covering social media use, including compliance with applicable state and federal regulations;
- Performing annual risk assessments on the firm's social media activities;
- Requiring pre-approval for employees setting up business social media sites;
- Reviewing and monitoring firm and employee social media postings and updates;
- Implementing a due diligence process covering third party providers;
- Developing controls for retention of all required records pertaining to social media use;
- Ensuring privacy safeguards are in place;
- Implementing appropriate disclosures, as needed; and
- Training employees on firm policies and regulatory requirements.

Conclusion

There are new social mediums being created continuously and user participation is on the rise. Many social media sites are either free to use or very economical, so it is likely financial firms will continue to rely on, and even expand their use of such sites to promote their business and communicate with clients. Consequently, compliance personnel need to remain alert as to these social media forums while taking into consideration regulatory guidance in this ever expanding area. It is important to develop a strong social media risk management program with active oversight. ✦

10 FINRA Regulatory Notice 10-06 – Social Media Websites (Jan. 2010) at http://www.finra.org/sites/default/files/NoticeDocument/p120779.pdf.
11 FINRA Investor Alert – HYIPS Hazardous to Your Portfolio (Jul. 15, 2010) at http://www.finra.org/investors/alerts/hyips%E2%80%94high-yield-investment-programs-are-hazardous-your-investment-portfolio.
12 FINRA Annual Regulatory and Examination Priorities Letter (Feb. 8, 2011) at http://www.finra.org/sites/default/files/Industry/p122863.pdf.
13 FINRA Annual Regulatory and Examination Priorities Letter (Jan. 31, 2012) at http://www.finra.org/sites/default/files/Industry/p125492.pdf.
14 FINRA Targeted Exam Letter (Jun. 2013) at http://www.finra.org/industry/spot-check-social-media-communications.
15 FINRA Quarterly Disciplinary Review (Apr. 2015) at http://www.finra.org/sites/default/files/Quarterly-Disciplinary-Review.April-2015.pdf.

Key Risks Facing Private Equity Fund Managers Series

Part 1 of 3: Performance Presentations

Courtesy of ACA Compliance Group

About the Series

This series will shed light on key regulatory risk areas for private equity fund managers recently highlighted by SEC staff via public forums or public statements. Each article will provide readers with a brief background on and industry observations regarding the risk area, as well as offer practical recommendations aimed at reducing these risks.

Background on Performance Presentations

Providing performance metrics to current and prospective clients or investors is standard practice in the investment management industry. Rule 206(4)-1 under the Investment Advisers Act of 1940 ("Advisers Act"), as well as related guidance from the U.S. Securities and Exchange Commission ("SEC") staff, governs and guides registered investment adviser use of advertisements and marketing materials, including the presentation of performance within those materials.

Further, Rule 206(4)-8 under the Advisers Act states that investment advisers to pooled investment vehicles must, among other things, refrain from making an untrue statement of a material fact to any investor or prospective investor. Such advisers must also divulge any material facts necessary to ensure the statements made are not misleading.[1]

Recently, certain SEC staff members have voiced concern regarding performance return calculations and disclosures. Not surprisingly, the industry is now seeing a heightened focus on the issue during examinations. This article will describe the reasons behind the SEC's attention to this topic, provide observations regarding compliance oversight in this area, and make practical recommendations to reduce related risks.

Recent Commentary from SEC Staff

In March 2012, legislative changes required many private equity fund managers to register with the SEC.[2] Since then, the private equity industry has been under the regulatory microscope. The scrutiny has concentrated on several concerns, including performance advertising.

In January 2013, Bruce Karpati, then chief of the SEC's Asset Management Unit, addressed industry professionals at a private equity compliance event in New York City. In his speech, Mr. Karpati discussed specific private equity enforcement concerns, including the valuation of illiquid assets during fundraising periods.[3] He indicated that SEC exam staff observed misconduct that involved marking up assets during a fundraising period and then marking them back down after the fundraising ends.

In January 2014, the SEC's National Examination Program published its examination priorities for the upcoming year. Performance marketing and presentation appeared on the list of core risks. The letter stated that the SEC would review the accuracy and completeness of adviser claims regarding investment objectives and performance.[4]

The drumbeat continued in May 2014 at another private equity compliance event in New York City. At that event, Andrew Bowden, then Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), delivered his infamous "Spreading Sunshine in Private Equity" speech. This talk highlighted key findings made by OCIE during recent examinations of private equity fund managers and reinforced marketing and valuation as important concerns for SEC exam staff. In addition, Mr. Bowden emphasized that examiners were reviewing marketing materials for other inconsistencies and misrepresentations, including those related to performance presentations.[5]

In May 2015, Marc Wyatt, Acting Director of OCIE, also addressed members of the private equity industry in New York City. During his presentation, Mr. Wyatt promoted the expertise OCIE has gained on the industry's particulars. He specifically mentioned the development of an examiner training program and the implementation of a knowledge-sharing structure within OCIE.[6] Although he did not directly speak of performance presentations, it was clear from his remarks that the SEC had boosted its knowledge in this area due to its focus on the specific performance calculations used by private equity fund managers and related disclosures.

Industry Observations

As noted, the industry has started to see closer inspection by SEC exam staff of adviser performance calculations and presentations

1 Rule 206(4)-8 defines a pooled investment vehicle as any investment company defined in section 3(a) of the Investment Company Act of 1940 and any privately offered pooled investment vehicle that is excluded from the definition of investment company by reason of section 3(c)(1) or 3(c)(7). This includes private equity funds, real estate funds, venture capital funds, hedge funds, and other types of privately offered pools that invest in securities.

2 The Dodd-Frank Act amended the Advisers Act registration provisions such that many advisers to private funds, including private equity funds, with more than $150 million in assets were required to register with the SEC by March 30, 2012.

3 See Bruce Karpati, "Private Equity Enforcement Concerns," Private Equity International Conference, New York, New York, January 23, 2013 [http://www.sec.gov/News/Speech/Detail/Speech/1365171492120].

4 See the NEP Examination Priorities for 2014 [http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf].

5 See Andrew J. Bowden, "Spreading Sunshine in Private Equity," Private Equity International (PEI) Private Fund Compliance Forum 2014, New York, New York, May 6, 2014 [http://www.sec.gov/news/speech/2014--spch05062014ab.html].

6 See Marc Wyatt, "Private Equity: A Look Back and a Glimpse Ahead," May 13, 2015 [http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html].

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and the subsequent raising of this concern in examination summary letters.

In particular, the SEC exam staff is citing advisers for failing to disclose their use of credit lines to bridge capital calls and the effect of such lines on internal rate of return ("IRR") calculations. IRR performance calculations are derived from cash flows in and out of a fund, and limited partner capital calls that are delayed by credit line use can reduce the time during which capital is outstanding. Shortening measurement periods can increase or reduce IRR depending on whether an investment performs positively or negatively.

Examiners are also citing firms for certain practices related to calculating and presenting net-of-fees IRR. Generally, net IRR calculations incorporate fees and expenses paid by fund investors as a way to show the actual performance realized. However, in practice, certain fund investors, such as the fund general partner, may not pay fees. Accordingly, including such investors in fund IRR calculations can exaggerate the fund's net performance relative to what a fee-paying investor would experience. The SEC exam staff is now viewing the inclusion of non-fee-paying investor capital in net IRR calculations without clear disclosure of the practice and the resulting effect on presented performance as potentially misleading.

Compliance personnel may not always fully understand the process for calculating performance returns or the methodologies used by their firms. Full confidence is often placed with the accounting, finance, or deal professionals computing performance numbers with an attendant assumption that these numbers are accurate and the related disclosures adequate. Given the risk in this area today, firms are increasingly using third parties to review and verify their performance return calculations for specific funds, investments, and time periods. These engagements often include a review of the firm's calculation methodologies as well as the supporting data and information and the work papers used to construct performance returns. The current demand for these services is being driven by the regulatory landscape, the SEC's focus on this area, and institutional investors seeking additional comfort before committing to a new fund.

Unfortunately, an accurate calculation does not necessarily mitigate all regulatory risk. It is critically important for compliance professionals to understand the process for calculating performance. With this knowledge in place, they can determine if and when calculation methodologies need to be adjusted or when additional disclosures to investors are necessary.

Practical Recommendations

Compliance professionals should take the following steps to fully understand the calculation of fund performance returns. First, they should identify the individual(s) within the firm who are responsible for calculating performance returns. Next, they should sit down with these individuals to discuss the process for selecting methodologies and the steps followed in calculating performance. In addition, they should review inputs and evaluate supporting documentation and work papers to better understand the nature of each calculation. If the firm uses a fund administrator or other third party to calculate performance returns, the compliance professionals should have similar discussions with them.

During this process, the compliance staff should pay close attention to how all fund and investor fees and expenses are treated in order to identify any arrangements or circumstances that require additional disclosures. Of particular importance is ensuring that the carried interest calculation, including the application of the "waterfall" set forth in the fund's governing documents, is error free. Compliance staff should then review written policies and procedures, as well as current performance disclosures, and make any necessary changes and enhancements.

It may be beneficial for compliance staff to meet regularly with process owners to confirm that processes and practices continue to adhere to written policies and procedures, disclosures appearing in Form ADV, fund operating documents, and fundraising materials, as well as other performance-related representations made to current and prospective investors. Such discussions could take place, for example, in conjunction with the testing performed to satisfy Rule 206(4)-7 under the Advisers Act, which requires registered investment advisers to review their compliance programs annually.

Going Forward

The SEC will continue to concentrate on adviser use of performance returns. Consequently, the private equity industry should expect performance presentations to be a focus area for the foreseeable future and take necessary precautions. Again, even if performance returns are calculated with perfect accuracy, they can still create regulatory concerns if the disclosures surrounding them are not adequate and/or do not describe all material facts and circumstances. ✦

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The Complexities of Distributing Complex Products

By Anna Pinedo

Regulators in the United States, including both the Securities and Exchange Commission (SEC) and FINRA, have expressed concerns regarding the sale of complex products by broker-dealers. Regulators have cautioned that retail investors may not understand fully the features, risks, and potential costs associated with certain products and may be unduly focused on the often attractive yield to be obtained through investments in complex products. Similarly, outside of the United States, a number of regulators in Europe also have become increasingly focused on the sale of complex products and have issued guidance relating to the steps to be taken in vetting these new products. This scrutiny suggests that broker-dealers should take a close look at their policies and procedures relating to new and complex products and review each step along the product development, introduction, sales, marketing and post-sales process. This brief overview is intended to provide some guidance on the areas that may merit close scrutiny.

Background

In January 2012, FINRA released Regulatory Notice 12-03 entitled "Complex Products: Heightened Supervision of Complex Products." Instead of providing a definition of a "complex product," the notice identifies in general terms the types of products that may be considered "complex" and provides guidance to member firms regarding supervisory concerns associated with sales of complex products. The notice notes that "any product with multiple features that affect its investment returns differently under various scenarios is potentially complex." The Notice goes on to say that a product is potentially complex "if it would be unreasonable to expect an average retail investor to discern the existence of these features and to understand the basic manner in which these features interact to produce an investment return." The notice singles out as complex those products that include complicated or ,intricate derivative-like features, such as a wide variety of structured notes (i.e., range accrual notes, reverse convertibles, steepener notes, notes with knock-in features, etc.), certain exchange-traded funds, hedge funds and asset-backed securities. In various public statements, FINRA representatives have noted that they are reluctant to provide an exhaustive list of the types of products that may be deemed "complex" given that market developments may cause certain products to become more popular and well-understood and new products to be introduced. As a result, it remains the broker-dealer's responsibility to determine whether a product is likely to be considered "complex." In all likelihood, this determination would be made after the fact when a retail client claims that it did not understand and could not reasonably have been expected to understand the product's features.

Product Approval

FINRA member firms are subject to heightened standards in relation to the sale of complex products. Therefore, member firms must implement a rigorous new product approval process, which specifically considers the questions suggested by FINRA in its Notice 12-03. Broker-dealers may, from time to time, consider reviewing their new product committee process in order to ensure that the committee includes representation from a broad cross-section of groups within the firm, including representatives from legal and compliance. The charter of the new business committee also should be reviewed to ensure that the committee is charged with and has the authority to request all of the information that members may consider relevant in vetting a potential new product. The committee also should be guided by written procedures. In the Notice, FINRA suggests that member firms consider the following:

- For whom is the product intended
- Whether the produce will be offered to retail
- The product's investment objective
- Whether or how the product adds to or improves the firm's product offerings
- What assumptions underlie the product
- How the product is intended to perform under various market scenarios
- The risks to investors and the anticipated liquidity
- How the firm and registered representatives will be compensated
- Whether the product introduces new conflicts of interest
- Any novel legal, tax, investment or credit risks posed by an investment in the product
- Whether the product's complexity impairs transparency regarding features or embedded fees
- Any new training requirements that should be imposed
- How the product will be distributed and by whom

Of course, this is a useful reference list, but firms will want to supplement this list and include additional questions to their new product approval forms. A firm will have its own questions or screening process in order to discharge its reasonable basis suitability obligation and the above should be considered in connection with those. Based on the information gleaned about the proposed new product during the committee's vetting process, the committee should be empowered to implement any of a number of tools. For example, the committee might consider approving the product only for a specified period of time as a trial period, subject to a follow-up review. The committee also should consider whether the product should be offered only to certain types of clients or to certain types of accounts (e.g., advised accounts, high net worth clients, etc.) or only through certain distributors if the firm relies on distributors to offer its products. The committee also may consider whether minimum denominations or minimum purchase requirements should be imposed in order to address suitability considerations. The committee also will want to add additional considerations for any new asset classes that may be unfamiliar to investors, as well as for any indices, especially proprietary indices, and products that contain embedded leverage.

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Training Requirements

The Notice reminds firms of their training obligations. Prior to commencing sales of any complex product, registered representatives should receive appropriate training. At the very least, a registered representative that is charged with selling a complex product must: understand the features and risks associated with the product; the payoff structure and the contingencies that may be associated with potential payments; the reference asset; the historic performance of the reference asset; any interdependencies in the performance of the reference asset and other variables that would affect the payoff; the expected performance of the product; any assumptions regarding the market conditions that would affect performance; the costs associated with the product; and whether there are similar products available to the customer.

FINRA has brought a number of disciplinary actions involving complex products. Many of these actions involve sales practice violations, such as misselling, which can be traced to a lack of understanding on the part of the sales person of the product's features. Effective training can help to mitigate the risk of misselling. Any training materials should be carefully reviewed in order to make certain that the materials are fair and balanced and adequately describe the risks associated with the product.

Suitability Assessments

Rule 2301 requires that in connection with recommending to the customer the purchase or sale of a security, the broker have reasonable grounds for believing that the recommendation is suitable for the customer based on the facts disclosed by the customer to the broker about the customer's financial needs and objectives. Once a product has been determined to be acceptable in light of the broker's reasonable basis suitability obligation, the broker must be in a position where it can discharge its customer-specific and quantitative suitability obligations. Again, FINRA has emphasized that member firms should adopt robust suitability policies and procedures that address complex products. A firm may consider, as suggested by Notice 5-59 and Notice 12-03, limiting sales of complex products to accounts that are approved for options trading. Otherwise, firms can develop other procedures designed to ensure that complex products are sold to customers with the financial sophistication to understand the product features and risks. Notice 12-03 advises that a registered representative who intends to recommend a complex product should discuss with the customer the product features, the product's anticipated returns under different market conditions, the risks and possible benefits, the costs, and the circumstances under which the performance may vary. After this discussion, the registered representative should evaluate whether the customer understands the basic features of the product. In various other notices regarding specific products, FINRA has highlighted specific risks that may be posed by such products.

In enforcement actions, FINRA has found that in connection with complex products certain member firms: did not have adequate supervisory systems and procedures to detect and prevent unsuitable sales, failed to provide registered representatives with sufficient training that would permit them to identify whether the recommended products were consistent with the customers' investment objectives, failed to identify excessive concentration of, or inappropriate trading of, complex products in client accounts, and lacked systems to prohibit purchases on margin.

Supervisory Systems

Given the special issues posed by complex products, member firms should ensure that their supervisory systems are adequate. For example, in FINRA enforcement actions, FINRA determined that certain firms did not have the capability to generate exception reports that captured trades in certain complex products. Similarly, another firm did not have in place a system that would permit the firm to monitor concentration of a particular type of product, reverse convertible notes, in client accounts.

Conflicts of Interest

FINRA has been particularly focused on conflicts of interests. In its 2013 report on conflicts of interest, FINRA noted that firms must address actual or potential conflicts of interest during the new product review process, as well as in subsequent post-approval reviews and determine whether conflicts (if any) can be mitigated or eliminated and how these conflicts will be disclosed to investors. The report comments specifically on the policies that firms implement with respect to conducting diligence in respect of any distributors ("Know Your Distributor" policies) and the extent to which the distributors have appropriate policies and procedures to address complex product sales. The report also discusses the conflicts that may exist in structured products due to the roles of the parties, such as, for example, when the broker-dealer or its affiliate acts as calculation agent for the relevant product, or for an underlying index.

Post-Approval Review

A member firm's responsibilities continue through to a post-sales review process. The Notice

reminded member firms that they should establish post-approval review processes in respect of new and complex products. The post-sale review process is intended to provide an opportunity for the firm to assess whether a product is performing as expected. A firm should design policies and procedures for the post-approval review that take into account the following factors, among others: any customer complaints received regarding the product, any regulatory developments that would affect the product, any questions received about the product from distributors or registered representatives that might suggest that additional training would be useful, the adequacy of disclosures used in marketing the product, the distribution channel for the product, the type of investors to whom the product is offered, the product's performance and the extent to which actual performance is consistent with expectations, competitor products or other products that may provide similar opportunities, costs and fees associated with the product, and any conflicts of interest that have presented themselves in respect of the product.

Conclusion

Although most of the FINRA actions to date have focused on misselling, it is important to recognize that effective policies and procedures can mitigate this possibility. It is reasonable to anticipate that regulators will continue to focus on complex products and review member firms' policies and procedures related to the vetting and sales of these products. As a result, it is important to acknowledge that the greater the complexity of a proposed product (at least in the eyes of a prospective investor), the greater the scrutiny that the legal and compliance groups should apply to each stage of the product's life.✦

Simons Says: Triple Play

By Tim Simons

I have three topics that I would like to briefly discuss: the proposed changes to Form ADV and some rules under the Investment Adviser Act; the SEC's Boston Regional Office and their whistleblower review; and an SEC staffer's reading of Section 17(e) of the Investment Company Act.

Proposed Rule Amendments

On May 20th, the SEC proposed "…rules, forms, and amendments to modernize and enhance the reporting and disclosure of information by investment advisers and investment companies." In plain English, that means more information reported to the SEC and the investing public, more frequently. Fortunately, the rules and amendments are only proposed, and open for comment for 60 days after publishing in the Federal Register. Only two comments have been received and posted by the SEC through May 27th, apparently by small advisers, and neither of the two thought that the changes were for the better.

One item on the IC side, that did strike me as odd, was the request for the monthly reporting of the "terms of derivatives contracts" held by the fund. I don't recall that information as normally requested by investors, but this may just be a sign of the increasing sophistication of today's mutual fund investor. There is also a new requirement for monthly portfolio reporting as well as additional annual reporting.

I want to primarily talk about the changes affecting investment advisers, "…to provide additional information for the Commission and investors to better understand the risk profile of individual advisers and the industry as a whole."

The changes to Form ADV Part 1 typically require more information and more specific information, such as types of assets held in separately managed accounts, borrowings and derivatives, and the identity of the custodians where those assets are held. My sense is that larger firms with more staff (and potentially more conflicts of interest) will be easily able to comply with the amended rules, but smaller advisers will not (as evidenced by the comments on the SEC's website). There is also a new requirement to identify the social media platforms that the advisers use.

The change that is the most troubling to me is the amendment to the Books and Records Rule. We are all familiar with the requirement that advisers retain supporting documents for any materials provided, directly or indirectly, to more than 10 persons. The proposed amendment would require the retention of the supporting documentation for materials including performance provided to **any** person. I assume this to mean that for any mention of performance in an email, you would need to have the supporting documents. I agree with the commenters that this creates a burden for advisers, especially the smaller advisers, but maybe the result will be less discussion about performance in your correspondence.

Please, if you have any concerns about these proposals, send your comments to the SEC. The more feedback, the better.

Whistleblower Review

The SEC's Boston Office appears to be conducting a sweep exam on whistleblower policies and procedures. That Office has requested documents be provided to them with no currently identified intention to visit the Firms involved. This is interesting in that whistleblowers were not identified by the SEC as an examination priority for 2015, and the SEC has already resolved two cases this year, one for muzzling a whistleblower, and one for retaliating against a whistleblower. So far, I only know of one instance in Boston, so this may be a local and not a national sweep, although the information was to be provided by May 29, so we may see additional nominees, over time.

The request list didn't ask for anything outside the expected for a whistleblower exam: compliance policies and procedures pertaining to Confidentiality/Whistleblower topics, current Code of Ethics, documentation of any violations relating to Confidentiality/Whistleblower topics and any action taken as a result, employment agreements with confidentiality and non-disparagement clauses, and any other policies regarding whistleblowers not already provided.

Investment Company Act Section 17(e)

Apparently, at a recent Investment Company Institute meeting, a member of the SEC's Investment Management staff told the attendees that he reads the prohibitions in Section 17(e) of the Investment Company Act to be a zero tolerance policy prohibiting ALL gifts – regardless of how nominal their value– that are given to ANY advisory employee from a broker-dealer that is used or may be used to execute portfolio transactions. In his view, this includes any business dinner paid for by a broker-dealer as well as the nominal gift baskets sent around holidays.

Why is this cause for concern?

Investment Company Act Section 17(e)(1) states:

(e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker;

This interpretation is obviously different from the manner in which fund advisers [and their outside counsel] have long read Section 17(e). Items of de minimus value have not been considered compensation in recent years, but I'm sure that the ICI staff will track this down and ensure that this is a not a new interpretation, but merely one Staffer's view. None of the Investment Management guidance to date seems to take such an extreme interpretation. In fact, gifts of de minimus value have typically been considered acceptable. As one individual pointed out, how could a tin of cookies shared over an entire office at Christmas time be considered compensation? At times like this, we need to remember that speakers from the SEC (including the Chair), start every public speaking engagement with the statement that the views

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expressed are their own and do not necessarily reflect those of the Commission nor other members of the Staff. Unfortunately, this individual either did not make that statement, or those reporting the incident failed to notice it.

My Perspective

Obviously, there is a lot going on right now, and, although it is nice to see something from the SEC that is not Dodd-Frank related, these changes to the Rules and additional reporting requirements do not seem to be making things better for the adviser, and providing more information to a prospective client may be more overwhelming than informative. My opinion is that an SEC fiduciary rule, or notice that the SEC will work with the Department of Labor to make their fiduciary rule workable, would mean much more to the industry. Anyone with issues that they feel need to be discussed by the industry can reach me at: tim@focus1associates.com. ✦

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ANNOUNCEMENT

Preparing Municipal Advisor Professionals to Take the MSRB's Pilot Series 50 Exam

By Loretta Jones, Director of Professional Qualifications, Municipal Securities Rulemaking Board

The Municipal Securities Rulemaking Board (MSRB) is implementing the first mandatory qualifying examination for individuals who provide municipal advisory services to state and local governments. Later this year, the MSRB plans to administer the Municipal Advisor Representative Qualification Examination (Series 50) as a pilot test to validate the bank of exam questions and set the passing score for the permanent exam.

While participation in the pilot is voluntary, all municipal advisor representatives and principals are required to take and pass the Series 50 within one year of the launch of the permanent exam. Any candidate who takes and passes the pilot Series 50 will be qualified as a municipal advisor representative and will not be required to take the permanent exam. Compliance officers at many municipal advisor firms are encouraging their municipal advisor professionals to take the pilot Series 50 for the opportunity to come into compliance with the MSRB's qualification standards in advance of the deadline.

To assist municipal advisor professionals considering participating in the pilot, the MSRB hosted an educational webinar on Thursday, June 11, 2015 to review the content outline for the test and discuss the enrollment process for the pilot.

Content of the Series 50 Exam

The Series 50 will test a candidate's general knowledge of the municipal advisory business, as well as regulatory requirements, including MSRB rules, Securities and Exchange Commission (SEC) rules, rule interpretations and other federal laws applicable to municipal advisory activities. The MSRB published a content outline for the exam that includes exam topics, sample questions and additional reference material that candidates may find useful in preparing for the test. The exam will consist of questions from five topic areas, organized as "functions:"

- Function 1: Understanding SEC and MSRB Rules Regarding Municipal Advisors (12 questions)
- Function 2: Understanding Municipal Finance (35 questions)
- Function 3: Performing Issuer's Credit Analysis and Due Diligence (12 questions)
- Function 4: Structuring, Pricing and Executing Municipal Debt Products (31 questions)
- Function 5: Understanding Requirements Related to the Issuance of Municipal Debt (10 questions)

A volunteer committee of municipal advisor professionals developed the content outline for the exam from information obtained from focus groups of municipal advisor professionals. Their work was ratified by a nationwide survey of registered municipal advisors as well as focus groups of municipal advisor professionals.

Administration of the Pilot Test

The MSRB intends to offer the pilot Series 50 exam for a 30-day period in September 2015. The specific dates will be announced in a notice published on the MSRB's website, at MSRB.org. The MSRB works with the Financial Industry Regulatory Authority (FINRA) to administer its professional qualification exams. Firms must utilize FINRA's Form U10 to enroll for the pilot Series 50 on behalf of their municipal advisor professionals. The MSRB will announce when the enrollment window for the pilot has opened, and provide information about how to schedule an appointment to take the exam during the 30-day pilot period.

The pilot Series 50 will consist of 100-125 multiple choice questions, with each candidate receiving a unique set of questions from a randomized bank of exam questions. The content covered on the examination will be the same for all candidates. Candidates for the pilot Series 50 will be allotted 4.5 hours to complete the exam.

Approximately three months after taking the pilot Series 50, candidates will receive a letter from the MSRB notifying them of their examination results. A candidate who fails to pass the pilot examination will be permitted one free retake when the permanent exam is available, and the failure of the pilot Series 50 will not appear on a candidate's CRD record. Importantly, a failure of the pilot exam will not count as one of the three opportunities a candidate has to take and pass the examination before having to wait a period of six months to re-take the exam. A candidate who takes and passes the pilot Series 50 will be qualified as a municipal advisor representative and will not be required to take the permanent exam. ✦

Resources

- Read answers to FAQs on the Pilot Series 50 Exam.
- Access more information about municipal advisor professional qualification requirements and up-to-date exam information on the MSRB's website.
- Sign up to receive email updates about the pilot exam.

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