A Survey of Compliance Developments in the Securities Industry in 2013

By James J. Eccleston and Christine E. Goodrich

Introduction

Over the past year, the securities industry has seen a number of significant changes and developments. The changing of the guard at the Securities and Exchange Commission ("SEC") has ushered in an era of aggressive enforcement and an increased focus on promoting an industry-wide culture of compliance. As a self-regulatory organization ("SRO") regulated by the SEC, the Financial Industry Regulatory Authority, Inc. ("FINRA") has promulgated guidance that similarly reflects an aggressive focus on compliance. As detailed below, the regulatory changes and guidance issued by the SEC and FINRA provide a comprehensive overview of important compliance developments throughout 2013 as well as a roadmap for the future of the securities industry.

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Regulatory Developments

a. SEC Amendments to the Securities Act of 1933

Lifting the Ban on General Solicitation

For the first time in nearly 80 years, the ban on advertising private securities has been lifted and mass marketing of securities not formally registered with the SEC is permitted. The historic lifting of the ban has created buzz and excitement amongst small businesses, entrepreneurs and start-up companies, as well as other entities, all of which now have additional avenues to access capital.[1] Historically, only larger companies that could afford to spend significant amounts of money in order to be listed on a major stock exchange were allowed to fundraise from the general public.

In July 2013, the SEC adopted various amendments to the Securities Act of 1933 ("the 1933 Act") regarding Regulation D and Rule 506, as mandated by the Jumpstart Our Business Startups

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("JOBS Act"). Prior to the implementation of Title II of the JOBS Act on September 23, 2013, early stage private companies were not allowed to advertise in order to raise capital from the general public. The exemption from SEC registration for private securities applied to Regulation D, Rule 506 offerings provided that the offering is not publicly advertised and that the purchasers are "largely qualified institutions or 'accredited' investors."[2] An investor is an accredited investor if the individual has a net worth greater than $1 million, exclusive of the individual's primary residence, or if their income exceeds $200,000 individually or $300,000 for couples.[3] Under Title II of the JOBS Act, the ban on general solicitation may be lifted so long as the issuer "reasonably believes and has taken reasonable steps to verify that the buyers of the private securities are in fact accredited."[4]

The regulatory changes and guidance issued by the SEC and FINRA provide a comprehensive overview of important compliance developments throughout 2013 as well as a roadmap for the future of the securities industry.

Private fundraisings that involve general solicitation pursuant to the new rule 506(c) trigger heightened due diligence and compliance obligations. While traditionally funds only had to reasonably believe that an investor was accredited, Rule 506(c) "upends accepted practice" by expanding that requirement and mandating that funds take "reasonable steps to verify" that they are selling securities only to accredited investors.[5] The new Rule 506(c) identifies four safe harbor methods in order for funds to satisfy the aforementioned requirement with respect to natural persons. In order to satisfy one or more of the safe harbor methods, private funds that engage in general solicitation "should review and revise both their offering documents and investor onboarding procedures."[6] To do so, funds will need to obtain private financial information and a certification as to the individual's income or net worth from either an SEC-registered entity or a licensed professional regarding the individual's accredited investor status.[7] While funds are not required to satisfy the reasonability requirement with respect to natural persons through one or more of the safe harbors, failure to do so will provide less regulatory certainty.

While unregistered offerings in the US are no longer subject to the ban on general solicitation, the same is not necessarily true internationally. Securities regimes both domestically and abroad will now be out of sync, as regimes abroad followed the old Rule 506 prohibition on general solicitation.[8] Consequently, funds may experience difficulty with various types of advertising and solicitation, such as websites, that could reach international audiences. Moreover, although federal statutes have lifted the ban, many states still prohibit general solicitation and advertising. Despite federal preemption of state law for offerings qualified for Rule 506(c) safe harbor, solicitation in states where the ban remains in effect would signify loss of safe harbor and trigger state registration requirements, meaning the fund might be in compliance with federal law yet simultaneously non-compliant with state law.[9] Private funds must ensure that their reliance on Rule 506(c) satisfies both state and federal requirements. Accordingly, private funds that plan to rely on Rule 506(c) should "identify states in which they intend to solicit investors and to understand the particular offering restrictions and risks of non-compliance in those states."[10]

Disqualification of "Bad Actors"

The "bad actors" rules refer to the disqualification of issuers from relying on Rule 506(b) and Rule 506(c) where the issuer or any other "covered person" experiences a "disqualifying event" within five to ten years of an offering, which is referred to as the "look back" period. For a private fund, "covered persons" include, but are not limited to, the fund, any beneficial owner with an interest of 20% or more in a private fund's outstanding voting equity securities, all affiliated issuers, the directors and officers of the fund, and any person compensated for soliciting investors.[11]

The bad actors rules can function as a five to ten year ban on a person's or entity's participation in an offering pursuant to Rule 506, depending upon the disqualification. For a natural person, a disqualification may be remedied by removing the individual from his/her position with the fund. In the event of the disqualification of an entity from a private fund complex,

however, the impact on the fund could be far-reaching and detrimental, as it could prevent the fund complex from being able to rely on Rule 506, among other consequences.

Proposed Additional Amendments

At the same time that the SEC adopted the aforementioned amendments, it also proposed additional amendments that would have far-reaching and significant implications if adopted, regardless of whether the private funds and their advisers plan to utilize general solicitation.

Form D Filings:

When a fund relies on Rule 504, 505 or 506 for sales of unregistered securities under the 1933 Act, the fund is supposed to file a Form D in connection with the Regulation D safe harbor. However, while the Form D safe harbor is not conditioned upon filing a Form D, failure to file a Form D may result in disqualification from reliance on the Regulation D safe harbor in future offerings "where a court has enjoined the issuer for such failure."[12] As the SEC believes stronger penalties would incentivize more issuers to file a Form D, the proposed amendments would update the SEC's Form D requirements to: "(i) expand the range of information called for; (ii) establish new filing requirements in connection with Rule 506 offerings; and (iii) condition future reliance on Rule 506(b) and Rule 506(c) on satisfaction of the Form D filing requirements."[13] The proposed amendments would also institute certain penalties for failure to comply. However, the proposed amendments would also make a 30-day "cure period" available to issuers, but "only to the extent that they fail to file a Form D or Form D amendment on a timely basis, and only once with respect to any particular offering."[14]

Sales Literature Guidance:

The SEC's proposed amendments would also amend Rule 156 of the 1933 Act to include "all private funds" irrespective of whether they engage in general solicitation. Rule 156 is not a safe harbor for compliance with anti-fraud provisions, but rather highlights various factors firms should consider in order to determine whether representations contained in sales literature are likely to violate statutory anti-fraud provisions.[15]

General Solicitation Requirements:

In addition to the aforementioned proposed amendments, the SEC would add Rule 509 to Regulation D. Rule 509 would require private funds to include the following disclosures in all written general solicitation materials:

- "Interests in the fund may be sold only to accredited investors, which for natural persons are investors who meet certain minimum annual income or net worth thresholds;
- Interests in the fund are being offered in reliance on an exemption from the registration requirements of the [1933 Act] and are not required to comply with specific disclosure requirements that apply to registration under the [1933 Act];
- The SEC has not passed upon the merits of or given its approval to the fund interests, the terms of the offering, or the accuracy or completeness of any offering materials;
- Interests in the fund are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their interests;
- Investing in fund interests and other securities involves risk, and investors should be able to bear the loss of their investment; and
- Interests in the fund are not subject to the protections of the Investment Company Act." [16]

Private funds that include performance data in their solicitation materials would also be required to disclose additional details regarding the performance data. Further, solicitation materials regarding performance data that do not reflect the deduction of fees and expenses would need to disclose that such fees and expenses have not been deducted and if they had been, the performance data might be lower than presented. Finally, the SEC would propose a temporary rule requiring issuers to submit any written solicitation materials, prepared by or on behalf of the issuers, to the SEC for a period of two years after the adoption of the proposal.

b. FINRA: Notable Regulatory Notices and Rulings

Communications with the Public Regarding Unlisted REITs

Issued in May 2013, Regulatory Notice 13-18 provides guidance for firms in describing certain real estate programs to their customers. Firms are required to ensure that their communications provide a fair and accurate explanation of how the real estate investment trusts ("REITs") operate. Communications need to be consistent with the representations in the program's current prospectus. FINRA noted the importance of avoiding communications that misleadingly

imply an investor's participation in a REIT is a "direct investment in the real estate itself or any other assets owned by the program."[17] One way that communications can be misleading in this regard is when firms include pictures of real estate not owned by the program without the appropriate accompanying disclosures.

In accordance with FINRA Rule 2210, which requires that a broker-dealer's communications are fair, balanced and not misleading, FINRA also stressed that firms should "balance any presentation of the potential benefits of [REITs] with disclosure concerning potential risks."[18] If the communications include risks disclosures presented in a "clear and prominent manner, commensurate with the discussion of benefits" in a location other than a footnote, the balance will be achieved.[19] Notably, FINRA stated that providing risk disclosures in the prospectus does not substitute for the required disclosures, even if the communication is "accompanied or preceded by a prospectus."[20]

So as not to confuse investors that the REIT is similar to a bond or note, communications are not allowed to include information that misrepresents the amount or composition of a REIT's distribution, nor may communications imply that the distribution rate of a REIT is a yield. In addition to numerous specific disclosures regarding distribution rates, FINRA indicated that firms may not include an "annualized distribution rate until the program has paid distributions… at least two consecutive quarterly periods."[21] FINRA stressed that firms may not indicate in communications that the value of the REIT is stable or that its volatility is limited. It is important for firms to communicate that the value may fluctuate and that the investor may not be able to sell his or her investment. Further, FINRA noted the importance of including the restrictions and limitations of redemption features of REITs, including, but not limited to, the fact that the REIT's management may terminate or modify investors' ability to redeem. Similarly, if a REIT has not satisfied all redemption requests in the past, that disclosure should be included as well.

Expanded Expungement Guidance

In an effort to bring increased scrutiny to expungement relief, in October 2013 FINRA released a "Notice to Arbitrators and Parties on Expanded Expungement Guidance."[22] The new expungement guidance stressed that the granting of expungement relief is "an extraordinary remedy that should only be granted under appropriate circumstances."[23] Further, FINRA noted that "information should only be expunged when it has no meaningful investor protection or regulatory value" and that the grounds set forth in FINRA Rule 2080 are the only grounds upon which expungement may be granted.[24]

An arbitration panel may only grant expungement relief when the arbitrators "find and document one of the narrow grounds specified" in FINRA Rule 2080(b)(1)(A)-(C).[25] The grounds specified in FINRA Rule 2080 where expungement relief is appropriate under FINRA's new guidance include the following: "(A) the claim, allegation or information is factually impossible or clearly erroneous; (B) the registered person was not involved in the alleged investment-related sales-practice violation, forgery, theft, misappropriation or conversion of funds; or (C) the claim, allegation, or information is false."[26]

Brokerage and Individual Retirement Account Fees

FINRA noted that in recent examinations, it has noted "overly broad language in sales materials of broker-dealer firms that implies there are no fees charged to investors who have accounts with the firm."[27] It would be inconsistent with FINRA Rule 2210 for firms to imply that accounts are free, considering there are always other associated fees, taxes and/or expenses levied by the firms. Accordingly, any communication regarding fees "must be accompanied by clear disclosure of the types of fees that may be charged."[28] Importantly, FINRA noted that it is not sufficient to include such disclosures in a footnote unless that placement "would not inhibit an investor's understanding of the communication."[29]

On the Horizon: Guidance from the SEC & FINRA

a. Conflicts of Interest

In October 2013, FINRA released a detailed report regarding the conflicts of interest faced by the financial services industry, as conflicts of interest "can arise in any relationship where a duty of care or trust exists between two or more parties, and, as a result, are widespread across the financial services industry."[30] The report reflects conclusions reached by FINRA as a result of its conflict initiative, an investigation into the

conflict management practices of a sampling of broker-dealers, launched in July 2012. The objective of FINRA's report is to assist firms in fashioning their approaches to identifying and managing conflicts in three key areas: enterprise level frameworks to identify and manage conflicts of interest; approaches to handling those conflicts; and approaches to compensating the associated persons of broker-dealers.

Enterprise-Level Conflicts Governance Framework

In order to effectively identify and manage the conflicts of interest firms face, FINRA emphasized the importance of employing a top-down approach where upper-level management would require "not only adherence to the letter of the law, but a commitment to the highest ethical standards and to putting customers' interests first."[31] While the "tone from the top" is an important first line of defense for conflict management, the structure, policies, processes, controls and training a firm utilizes are all essential components of an effective conflict management framework. Importantly, FINRA noted that many of the conflict management measures discussed in the report would be ineffective in the absence of the proper "tone from the top."

While the framework for addressing conflicts will vary based on the scale and scope of the firm's business, FINRA noted that all firms should address conflicts proactively, rather than in an ad hoc manner. FINRA stated that its conflict initiative revealed several elements of an effective conflict management framework, including, but not limited to, the following:

- "Defining conflicts of interest in a way that is relevant to a firm's business and which helps staff identify conflict situations;
- Articulating employee's roles and responsibilities with respect to identifying and managing conflicts;
- Establishing mechanisms to identify conflicts in a firm's business as it evolves;
- Defining escalation procedures for conflicts of interest within and across business lines;
- Avoiding severe conflicts, even if that avoidance means foregoing an otherwise attractive business opportunity;
- Disclosing conflicts of interests to clients, taking into consideration the different needs of retail and institutional clients;
- Training staff to identify and manage conflicts in accordance with firm policies and procedures; and
- Reporting on significant conflict issues, including on a firm's own measures to identify and manage conflicts, to the Chief Executive Officer and the board."[32]

While not required, FINRA stressed the importance for firms to articulate the structures, policies and processes that comprise the firm's conflict management framework. Firms may also have additional committees or ad hoc bodies that they utilize as needed when conflicts arise. FINRA noted that it is an effective practice for firms to articulate ethical standards and firm-wide policies regarding conflicts management that are suited to the firm's size and complexity in order to assist employees in handling conflicts. FINRA also stressed that "employing ethical individuals is an integral part of maintaining a culture of compliance and integrity in which conflicts of interest are addressed fairly,"[33] noting its concern over the number of firms willing to hire associated persons with "problematic disciplinary histories."[34] Notably, when hiring an associated person, a firm must "affirmatively determine that the associated person satisfies FINRA's qualification requirements and is not subject to a "statutory disqualification" (regardless of whether that individual is required to be a registered person)."[35]

New Business and New Product Conflicts Review

Stemming from its concern regarding the increased sale of complex investment products to retail investors who frequently do not understand the features, risks and conflicts inherent in such products, FINRA stressed the importance of employing a conflicts management framework for new business initiatives and new products. When launching a new product or service, FINRA noted that firms employ the following effective practices for identifying and managing conflicts of interest:

- Mandate new product review committees in accordance with the "tone from the top" culture of compliance;
- Decline to offer products to customers where the product has the potential for serious harm to customers and the firm is unable to successfully mitigate that conflict;
- Differentiate between institutional and retail investors with regard to product eligibility;
- Institute strong "Know Your Distributor" (KYD) policies and conduct an in-depth assessment of the potential distributor before allowing the distributor to sell the manufacturer's products;

- Conduct reviews after a new product has been launched to assess whether a product has performed as expected;
- Evaluate whether registered representatives demonstrate sufficient understanding to perform a suitability analysis and effectively explain the new product to his or her customers, including the risks inherent in the new product, and provide training where necessary;
- Disclose the risks of the new product in plain English disclosures to customers of the firm; and
- Require written attestations by customers that they understand the product and its risks.

For firms that engage in both product manufacturing and private wealth management businesses, FINRA emphasized the importance for firms to have "conflicts controls for the private wealth business operating with appropriate independence from other business lines within a firm."[36] These controls would include, but not be limited to, maintaining effective safeguards against incentivizing the sale of proprietary products if such products would be a detriment to the customer, especially as firms "seek to leverage their brokerage and other platforms to cross-sell products and services. Notably, firms cannot rely on the due diligence of the issuer but must conduct their own due diligence. Firms that engage in revenue sharing arrangements or other selling agreements with third-party providers should "exercise the necessary diligence and independent judgment to protect their customers' interests."[37]

Compensation and Oversight

Compensation is an area rife with conflicts of interest because the rewards offered by the firm influence its registered representatives to behave in ways that affect customers' interests. To manage these conflicts, FINRA recommends that firms take an integrated approach that combines compensation, supervision and surveillance. The importance of supervision and surveillance is heightened where the conflict of interest is significant. Some effective practices FINRA noted include, but are not limited to, the following:

- Avoid compensation thresholds that would allow a registered representative to disproportionately increase compensation through an incremental increase in sales;[38]
- Monitor whether the sales activity of representatives is being influenced by an approaching compensation threshold;
- Create a neutral compensation grid whereby the incentive is minimized for registered representatives to favor one type of product;
- Avoid incentivizing the sale of proprietary products as opposed to comparable products; and
- Monitor the suitability of recommendations made around key liquidity events in the investor's life where "the impact of those recommendations may be particularly significant."[39]

FINRA noted that if firms fail to make sufficient progress regarding conflict management, the SRO would evaluate whether rulemaking requiring firms to implement policies to identify, manage and mitigate conflicts would enhance investor protection.

b. Expungement Procedures for Unnamed Persons

FINRA has proposed Rule 13807 which would allow for unnamed financial advisors to defend their interests in customer arbitrations through an "In re proceeding" in which they have not been named as a party. The unnamed person would be able to utilize the proceeding solely to expunge his or her record, and would not be able to name respondents, nor to seek any type of relief beyond expungement (such as monetary relief). An In re proceeding would not be able to commence until after the "underlying investment-related customer-initiated arbitration proceeding has concluded."[40] Presently, unnamed advisors do not have standing to bring an action to have their public records expunged. Consequently, proposed Rule 13807 would likely be a welcome change in the financial services industry. The SEC is expected to rule on the proposal in early 2014.

c. Aggressive Enforcement and a Culture of Compliance

With the recent change of the guard at the SEC, it is unknown on which areas of the securities industry the SEC will focus its investigative and enforcement powers, though several key developments help to provide insight. In April 2013, Chairman Mary Jo White was appointed to temporarily replace former Chairman Mary Schapiro. In contrast to her predecessor, Chair White spent about a decade of her career with the U.S. Attorney in the Southern District of New York prosecuting terrorists and organized crime. In a historical move, Chair White appointed co-directors for the Division of Enforcement who also have prosecutorial backgrounds. This represents the first time in the history of

the SEC that the Chairman and the Enforcement Division leadership are all former criminal prosecutors.[41]

Investigation of Smaller Infractions and Increased Enforcement Actions

In the nearly eight months since she was sworn in, Chair White has indicated that the SEC will pursue aggressive enforcement to breed a culture of compliance across the industry. Notably, in addition to larger infractions, the SEC will also focus more narrowly on minor infractions as a method of preventing larger-scale violations. Similar to the "broken windows" theory of policing, smaller offenses will be aggressively targeted in order to prevent the erosion of compliance from the bottom up. Specifically, the SEC's detection of lesser infractions on behalf of advisers "could spur interest in whether there are more serious violations, such as misleading registration information, inaccurate portrayals of investment performance and philosophy and improper fee disclosure."[42] This leads industry analysts to believe that in the future, more cases will be brought by the enforcement arm of the SEC that were previously dealt with through regulatory channels.[43]

Enforcement Priorities

In recent months, the SEC has signaled numerous areas where its enforcement powers will be focused. A renewed focus on public company accounting and reporting fraud is one such area, as is a continuing emphasis on the managers of hedge funds, private equity funds and investment advisers in general.[44] Notably, the SEC intends to focus on "private fund advisers (particularly those newly-registered under Dodd Frank and now subject to examination) who may be improperly acting as unregistered brokers)."[45] The SEC will also continue to focus on and aggressively prosecute cases of insider trading, as well as cases regarding fraud and other charges surrounding municipal securities. Targeting rogue brokers whose conduct harmed not only investors but also the brokers' firms will also continue to be a priority of the SEC's enforcement division, as well as brokers who are not registered in accordance with applicable securities laws.[46]

Increased Settlement Scrutiny

Chair White has indicated that the SEC intends to discontinue its long-standing practice of allowing defendants in enforcement actions to settle the matter without admitting or denying liability to the allegations therein. In select cases, the SEC would further require parties to make certain admissions as a condition of settlement. Those cases would likely include instances where there was "'egregious intentional misconduct' that harmed large numbers of investors, or where the defendant had obstructed the investigation."[47] The departure from the long-standing "neither admit nor deny" practice is likely a response to the controversy that SEC settlements have generated in recent years. Increased judicial scrutiny was perhaps most evident in November 2011 when District Court Judge Jed Rakoff of the Second Circuit Court of Appeals rejected the SEC's $285 million settlement with Citigroup stating that the allegations contained in the settlement, if not admitted by Citigroup, were "unsupported by any proven or acknowledged facts."[48] While Judge Rakoff's controversial ruling has been criticized and is being appealed by Citigroup, district courts across the country have followed in Judge Rakoff's footsteps in criticizing SEC settlements.

Despite the regulatory uncertainty approaching 2014, one thing seems clear: firms that effectively adopt cultures of compliance, combined with effective controls and procedures, will be most effective at combating corruption and consequently avoiding regulatory scrutiny.

The increased judicial scrutiny of settlements and the SEC's change in policy are likely to have severe repercussions for the securities industry. Namely, admissions of liability would have "serious collateral consequences in any related private action, or even an action brought by another state or federal regulator."[49] Moreover, as more SEC settlements are scrutinized in court, the SEC "is likely to file more actions as administrative cease-and-desist proceedings – not just in settled actions, but in litigated cases (in the event that a settlement may be reached before the hearing)."[50]

Conclusion

Clearly, we have witnessed a "more aggressive SEC" under Chair White.[51] Given that her appointment to a full term in 2014 seems likely, both those who support a more aggressive SEC and those who are wary of a more aggressive SEC undoubtedly will watch her closely.

Despite the regulatory uncertainty approaching 2014, one thing seems clear: firms that effectively adopt cultures of compliance, combined with effective controls and procedures, will be most effective at combating corruption and consequently avoiding regulatory scrutiny.

ENDNOTES

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