INVESTMENT MANAGEMENT UPDATE

Legal News℠

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A Compilation of Enforcement and Non-Enforcement Actions – December 2011

Enforcement Matters

SEC Takes Action Against Registered Advisers

Recent actions by the SEC against certain registered investment advisers demonstrates the SEC's increased efforts to "crack down" on those advisors who repeatedly fail to remedy compliance deficiencies. *Legal News: Investment Management Update* frequently reports enforcement actions by the SEC and state regulators as it helps demonstrate the types of compliance issues that cause the regulators to take enforcement action.

SEC registered investment advisers are subject to routine and special examinations by staff examiners of the SEC. The SEC examination includes a review of the adviser's compliance policies and procedures designed to address the requirements under the Investment Advisers Act of 1940 and other relevant federal securities laws. After the conclusion of the examination, the examination staff provides the adviser with a deficiency letter if deficiencies and/or violations were found. The adviser is required to respond to the deficiency letter describing the steps it will or has taken to address such deficiencies or violations. During the SEC's next visit to the firm, the examiners will especially review if the adviser has taken the steps it described in its previous post-exam response and whether such steps have been adequate to prevent such deficiencies or violations from reoccurring. If the staff believes that the adviser has failed to take the required action or the action taken was not effective, it may recommend that enforcement action be taken against the firm, the chief compliance officer, and/or other principals and employees of the firm. The recent enforcement actions as described below are examples where the adviser failed to take actions or effective actions to resolve the prior concerns noted.

In the matter involving Asset Advisors, LLC, a registered investment adviser based in Michigan (SEC Admin. Proc. File No. 3-14644), the firm was cited by the SEC for fully adopting compliance policies and procedures and applying a code of ethics, after such concerns were brought to the firm's attention by SEC examiners. For such non-compliance, the firm agreed to pay a $20,000 fine, cease operations, and withdraw its registration with the SEC. The firm's clients (with their consent) were to be moved to a registered investment adviser that has an established compliance program. The firm also was the subject of a cease and desist order and censure.

In another enforcement matter, Omni Investment Advisors, Inc. (SEC Admin. Proc. File No. 3-14643), an SEC registered investment adviser based in Utah, demonstrates what can happen when the adviser fails to take corrective action after receiving a warning about violations from the SEC. The firm's compliance officer, Gary R. Beynon, was separately charged by the SEC for allegedly backdating documents for the firm. The adviser was cited for failing to adopt and implement written compliance policies and procedures after SEC examiners informed the adviser of certain deficiencies. The adviser also was cited for failure to establish, maintain, and enforce a written code of ethics and preserve certain books and records. According to the SEC, Mr. Beynon backdated client advisory agreements one day before those documents were provided to the SEC in response to a document request. In order to settle the SEC charges, Mr. Beynon agreed to pay a $50,000 fine and a permanent bar from the securities industry. Omni agreed to provide a copy of the SEC's complaint to all persons who were clients during the three-year period when it had no compliance program.

In still another SEC enforcement action taken about the same time, Feltl & Co. (SEC Admin. Proc. File No. 3-14645), a Minneapolis-based SEC registered investment adviser, was cited for failing to adopt and implement written compliance policies and procedures, adopt a code of ethics, and collect the required securities holdings reports from its supervised persons. According to the SEC, the lack of written policies and procedures allowed the firm to engage in hundreds of principal transactions with its clients without informing them and first obtaining their consent, all as required under the Investment Advisers Act of 1940. In order to settle the SEC's enforcement matter, the adviser agreed to pay a $50,000 fine and return more than $142,000 to certain of its clients. The firm also agreed to provide a copy of the SEC's enforcement order to past, current, and future clients and prominently post a summary of the order on its Web site, and to engage an outside consultant to review its compliance operations annually for the next two years.

Non-Enforcement Matters

SEC Adopts Revised "Net Worth" Standard for Accredited Investors

On December 21, 2011, the SEC finalized its amendments to the individual accredited investor net worth standards under Regulation D of the Securities Act of 1933. Issuers that conduct private offerings of securities under an exemption from securities registration usually rely on the exemption found under Regulation D that permits sales of the securities in the offering to persons who are "accredited investors," as defined under Rule 501 of Regulation D. One way an individual investor may qualify as an accredited investor is if his or her net worth, or joint net worth with the investor's spouse, exceeds $1 million.

The Dodd-Frank Wall Street Reform and Consumer Protection Act on July 20, 2010 revised the accredited investor net worth standard to exclude the value of the investor's primary residence from the net worth calculation. Prior to that time, the value of the investor's primary residence was included in the calculation. Dodd-Frank also mandated that the SEC revise its rules to reflect the new standard. The SEC's final rule (contained in SEC Release No. 33-9287) implements that mandate. Accordingly, for private securities offerings relying upon the Regulation D exemption, a person who subscribes to purchase securities in such offerings, and who wishes to qualify as an accredited investor by having a net worth in excess of $1 million, will need to fit within the revised criteria. Under the SEC's amended net worth calculation, indebtedness secured by the person's primary residence, up to the estimated fair market value of the property, is not treated as a liability, except when the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess is included as a liability. In addition, any such indebtedness in excess of the fair market value of the residence is included as a liability.

This final amendment to the Regulation D exemption is effective 60 days from the date it appears in the Federal Register. There are no "grandfathering" provisions from this revised net worth requirement other than for purchasers who: are acquiring the securities under a right to purchase which right was held by the person on July 21, 2010; the person qualified as an accredited investor on the basis of the net worth definition in effect at the time the person acquired the right; and, was a securities holder of the issuer at that time the right was awarded.

It is estimated that prior to this net worth change for individual accredited investors under Dodd-Frank, approximately nine percent of U.S. households qualified for accredited investor status. It is further estimated that after the enactment of the Dodd-Frank provision, approximately six percent of U.S. households will qualify. This decrease in the pool of accredited investors will make it more difficult to raise capital in a private placement offering.

Issuers that are relying or will rely on the Regulation D exemption should amend their subscription or purchaser agreements to reflect the new net worth calculation requirements.

Proposed FINRA Rule 4516: Readily Identifiable and Accessible Records

In light of Lehman Brothers Inc.'s 2008 bankruptcy and its regulators' "inability to locate certain documents and information"[1] in connection with Lehman's liquidation, the Financial Industry Regulatory Authority (FINRA) recently proposed Rule 4516, which requires carrying and clearing firms to electronically maintain and automate certain customer records in an accessible location and designate a contact person[2] to FINRA responsible for maintaining firm records.[3]

If ultimately approved, proposed Rule 4516 would expedite the liquidation, transfer and orderly return of certain documents and customer account information if a FINRA regulated firm were to become insolvent. Under proposed Rule 4516, customer records must be "uniquely tagged and appropriately indexed" and kept current by indicating the last time such information was updated. The information should be "immediately available to and accessible by" FINRA, the SEC, and the Securities Investor Protection Corporation (SIPC) as opposed to the "promptly" or "easily accessible" standard as required in certain cases under Securities Exchange Act of 1934 Rule 17a-4.

In addition, FINRA regulated firms would need to establish an "agreement with any clearing agency, clearing bank or custodian with which the member firm does business that requires, upon the commencement of a liquidation of the member firm, that any electronic systems provided to the member firm by the clearing agency, clearing bank or custodian will be made available, on a read-only basis, to representatives or designees of FINRA, the SEC and SIPC."[4]

The recent bankruptcy filing of MF Global Holdings Inc. only reinforces the importance "pre-arranged" liquidations address and, although some recent comments to FINRA indicate that the Proposed Rule 4516 is administratively burdensome and will not necessarily improve or enhance record requests made under Rule 8210, it is thought that the MF Global case might serve to help clarify and strengthen FINRA's focus on this issue.

Under Proposed Rule 4516, each carrying or clearing member will be required to maintain current records containing the following:

1. Description of all accounts and ranges on the general ledger, including the names of the associated persons assigned primary and supervisory responsibility for each such account pursuant to Rule 4523(b)
2. Mapping of the general ledger accounts and ranges to the trial balance, including a list of all affiliated accounts
3. Description of all mission-critical systems as defined in Rule 4370(g), including recordkeeping systems and the names of contact

persons for each
4. List of all bank accounts, authorized signatories, copies of executed agreements with such banks, and "no lien" letters, where applicable
5. Identification of all accounts and ranges on the stock record
6. Identification of all foreign and domestic control locations pursuant to SEA Rule 15c3-3 with the names of contact persons at each institution
7. Copies of all executed subordination agreements and nonconforming subordination agreements
8. Copies of all executed agreements with any clearing agencies, clearing banks, and custodians
9. Copies of all executed agreements relating to the outsourcing of any significant activities or functions that are critical to the transfer of customer accounts and the liquidation of the member
10. Most recent copy of the member's business continuity plan

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[1] *See, e.g.*, In re Lehman Brothers Inc., Trustee's Preliminary Investigation Report and Recommendations (August 25, 2010), pages 112 *et seq*. (Trustee's Report).

[2] NASD Rule 1160 requires, among other things, each member firm to (1) report to FINRA all contact information required by FINRA; (2) update its required contact information promptly, but in any event not later than 30 days following any change in such information; and (3) review and, if necessary, update its required contact information within 17 business days after the end of each calendar year.

[3] FINRA Regulatory Notice 11-48 (Oct. 21, 2011).

[4] FINRA Regulatory Notice 11-48 (Oct. 21, 2011).

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