

Discovering Your Firm's Risk Status.....	3
SEC Moves Help Money Market Funds.....	3
Strategies to Ride Market Roller Coaster.....	5
Adviser in Hot Water Over CMOs.....	6

November 3, 2008

## Passage of time washes out anti-money laundering rule proposal

**FinCEN** finally has broken its silence about the fate of its five-year-old anti-money laundering [proposed rule](#): It's dead. The Treasury bureau concedes the "passage of time" justifies pulling the proposed rule and starting over again.

The proposal, which came out in May 2003, would have extended FinCEN's AML rules to investment advisers, unregistered investment companies and commodity trading advisers.

FinCEN believes it can take its time to release a new proposal and welcome industry comments because many of the entities advisers deal with already fall under its AML rules. It provided no timetable for a new proposal.

**Editor's Note:** Despite the FinCEN action, SEC officials and recent document request letters make clear examiners will quiz you about your AML program, which is why we've scheduled a webinar, [A Made-for-Advisers' Blueprint to Anti-Money Laundering Success](#).

Register for the Dec. 9<sup>th</sup> webinar at <http://www.iawatch.com/conferences/A1695/home.html>. ■

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## Donohue offers glimpse at SEC's coming books and records changes


President **Kennedy** roamed the Oval Office when the SEC created its books and records rule for advisers. Now – soon to be nine presidents later – the agency is poised to rub the tarnish off Advisers Act rule 204-2. **Andrew Donohue** , director of the SEC's Division of Investment Management, offered insights Oct. 29 before an **NRS** conference in Arizona on how the rule may change:

- **Require advisers to maintain some records in an electronic format.** Currently, this is only an option.
  - Create – and produce them, if the SEC asks – “**searchable and sortable electronic records** of trading data for managed accounts, clients lists, and code of ethics breach logs.”
  - **Update the proposed communications retention requirements.**
  - **Recommend advisers keep more categories of correspondence** involving “clients, advice, performance,


*(Books and Records, continued on page 2)*

*IA Week Exclusive*

## Threshold securities drop precipitously since September

It looks as though the SEC's actions since July to dampen abusive short selling are working. An **IA Week** analysis of Reg SHO threshold data reveal a rapid and steady decline in their numbers since Sept. 25<sup>th</sup>. Just days before this date the SEC issued a new emergency [order](#)  temporarily prohibiting the shorting of 800 securities.

The daily number of threshold securities has dropped 81% since Sept. 25, from 492 to 94 on Oct. 29<sup>th</sup>, according to data shared with **IA Week** by **John Welborn** of the **Haverford Group** in Salt Lake City. Welborn, who supports the SEC actions to deter naked short selling, provided **IA Week** with nearly four years of threshold data.

Reg SHO defines a “threshold security” as one that appears on the fails-to-deliver list for five straight days and the fails equal at least 0.5% of the issuer's outstanding shares. Some argue the [threshold list](#)  pinpoints targets of abusive naked short sellers. The trending in the data

*(Thresholds Fall, continued on page 2)*

## Books and Records (Continued from page 1)

compliance, commissions,” as well as audits, regulators, marketers and broker-dealers.

Donohue also advised listeners to review their disclosure policies, especially those involving conflicts of interests, and to revisit your firm’s assumptions regarding hedging techniques, portfolio diversification and portfolio liquidity. Take “a look at sales materials and pertinent disclosures to see if the information continues to be accurate” in light of recent market developments, he encouraged.

Also be sure if your firm operates on existing exemptive orders from the SEC that it continues to satisfy the orders’ requirements.

Donohue also put in a plug for compliance, echoing Director of the Office of Compliance Inspections and Examinations [Lori Richards](#)’ recent comments pleading that compliance not become a victim of industry cost-cutting. “The notion that a firm should include compliance and legal personnel among the group of employees to downsize can be in my view a serious mistake,” said Donohue. “I submit that the value of compliance and legal personnel increases during a down market.” ■

## Thresholds Fall (Continued from page 1)

gives credence to this view.

Consider that, since 2005, the number of securities on the daily threshold list peaked July 14<sup>th</sup> of this year, at 675. The next day the SEC announced its initial emergency [order](#) protecting 19 entities against short selling ([IA Week](#), July 21, 2008).

With few exceptions, the number of daily threshold securities has fallen since July – with the massive and consecutive drop-off beginning in late Sept. The first

trading day affected by the SEC’s emergency order that month was Sept. 22<sup>nd</sup>. Add in the customary three-day settlement window and you arrive at Sept. 25<sup>th</sup> – more evidence the SEC’s actions explain the steady dip in threshold securities. This trend is likely to continue in the wake of the recent rules the Commission enacted last month ([IA Week](#), Oct. 27, 2008).

## Fails-to-deliver data

A separate analysis by [IA Week](#) of the SEC’s fails-to-deliver data finds total fails increased 4.1% in the second quarter of this year to more than 66 billion shares ([IA Week](#), Sept. 22, 2008). Ironically, the data reveal fails actually decreased in the second quarter for 12 of the 19 securities protected by the Commission’s July order (see the table on page 3).

This could fuel critics of the SEC’s actions, such as [Richard Baker](#), president of the [Managed Funds Association](#) in Washington. He calls the recent SEC rules against shorting “an unfortunate and aberrant intervention into the market.”

Welborn says the agency’s actions “showed the SEC understands how to fix the problem” of abusive naked short selling. The test now, he says, is whether the agency will target violators of the new rules. “The onus is on the SEC ... to show that they are serious about enforcement,” he adds. If it isn’t, he says, the number of thresholds will eventually start to go up again. ■

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## SEC continues waiver of fees for advisers to use IARD

Citing the “current economic climate,” the **SEC** and **NASAA** have agreed to extend the current [waiver](#) of initial and annual fees for posting to the Investment Adviser Registration Depository (IARD) system. The waiver had been set to expire Nov. 1.

This extension runs through next July. ■

## Your examiner just might divulge your firm’s risk status

How often **SEC** examiners show up on your doorstep depends largely on how the Commission ranks your firm’s compliance [risk status](#). The agency contends it won’t tell you your [status](#). But sources tell us some examiners do.

The disclosure can come in the exit interview, according to a knowledgeable source. It could be an initial assessment, a firm decision or a recommended level, e.g., low, medium or high-risk.

“Every examiner is different,” notes **Janaya Moscony**, president of **SEC Compliance Consultants** in Philadelphia. Some may feel comfortable in telling a firm its risk level, especially if it’s low-risk.

If an examiner doesn’t volunteer the status, there’s no harm in asking for it, she says.

“If we feel you’re doing a really bad job [with compliance], we’ll tell you at the end of the exam,” **Gene Gohlke**, associate director of the SEC’s Office of Compliance Inspections and Examinations, said Oct. 20 at the 2008 **NSCP** meeting in Philadelphia. He didn’t say examiners would reveal your risk status, though.

Gohlke also said examiners look to see if a firm has missed compliance problems and will ask for a list of clients, AUM, investment style and performance. He further disclosed that all of the SEC’s regional offices should be using the new core document request letter, which runs about 8 pages ([IA Week](#), July 14, 2008). ■

## Moves by SEC show even safe investments need full disclosure

If you advise money market funds, several no-action letters and a temporary order by the **SEC** could bring you comfort, even as they flag the need to revise disclosures to clients about the risks of what not so long ago were iron-clad investments.

The ongoing credit crisis and market conditions prompted the actions. In one, the SEC gave **J.P. Morgan** a green light to establish a temporary program designed to gin up liquidity by setting up “special purpose vehicles” to purchase assets, such as bank notes, from money market funds.


“This was another act by the federal government to support the money market funds” by allowing them to sell poor performing securities in their portfolios, says **Bibb Strench**, partner at **Sutherland** in Washington. The move should give advisers “greater comfort,” he adds.

Money market managers should resist the temptation to have affiliates infuse capital or buy troubled securities in the funds, recommends **Andrew Donohue**, director of the SEC’s Division of Investment Management. He spoke before an NRS conference in Arizona Oct. 29. “If a fund acts too swiftly, it may inadvertently violate the securities laws,” he said. The recent no-action letters offer some relief in these cases, he added. (*Money Markets, continued on page 4*)

**Comparison of average daily reported fails-to-deliver shares for top investment houses**

Security	1 <sup>st</sup> Q. 2008	2 <sup>nd</sup> Q. 2008	% changed
Allianz SE (AZ)	487,553	82,481	-83.1%
Bank of America Corporation (BAC)	124,334	378,051	204.1%
Barclays PLC (BCS)	135,068	82,594	-38.9%
BNP Paribas Securities Corp. (BNPQY)	30,230	108,180	257.9%
Citigroup Inc. (C)	401,745	307,190	-23.5%
Credit Suisse Group (CS)	217,341	86,799	-60.1%
Daiwa Securities Group Inc. (DSECY)	NA	113,645	NA
Deutsche Bank Group AG (DB)	86,434	80,431	-6.9%
Fannie Mae (FNM)	112,413	180,722	60.8%
Freddie Mac (FRE)	160,520	131,828	-17.9%
Goldman, Sachs Group Inc (GS)	102,694	59,512	-42.0%
HSBC Holdings PLC ADS (HBC)	208,514	109,037	-47.7%
J. P. Morgan Chase & Co. (JPM)	108,797	197,745	81.8%
Lehman Brothers Holdings Inc. (LEH)	199,440	175,599	-12.0%
Merrill Lynch & Co., Inc. (MER)	80,823	96,261	19.1%
Mizuho Financial Group, Inc. (MFG)	179,533	121,377	-32.4%
Morgan Stanley (MS)	282,786	48,486	-82.9%
Royal Bank ADS (RBS)	544,072	1,283,741	136.0%
UBS AG (UBS)	247,803	395,413	-83.1%

## Money Markets *(Continued from page 3)*

A new [temporary order](#)  halts redemptions on **Reserve Municipal Money-Market Trust** funds. “The Funds have been subject to a heavy level of redemption requests,” the order reads. For example, one fund plummeted from \$1.78 billion to \$154.6 million in just a few weeks. The suspension in redemptions will give the funds time to liquidate “in an orderly manner.”

“It’s rare for the SEC to issue orders suspending redemptions for fund shares,” says the SEC’s **Douglas Scheidt**, associate director and chief counsel in the Division of Investment Management. It was necessary because the funds were threatened with running out of cash.

“This is one more additional surprise in a series of lots of surprises” over the last two months, says **Howard Suskin**, partner at **Jenner & Block** in Chicago. He notes some of these funds have been involved in litigation recently from shareholders who claim some investors got advanced notice and pulled out early.

The SEC last week also released a series of no-action letters that gives money market managers greater flexibility to sell their commercial paper. “These are temporary” moves, intended to last for three or four months, says **Robert Bagnall**, partner with **WilmerHale** in Washington.

These cases hold lessons for advisers. For one, the recent economic difficulties should make you aware that even secure, liquid vehicles may not be safe, says Suskin. Make sure you accurately describe the potential risks to your clients, he adds.


Scheidt says another lesson is funds should follow the SEC’s long-held guidance that at least 90% of a money market fund’s portfolio be liquid.


A Boston attorney says that was the case, and adds perhaps the SEC may wish to revisit its policy that restricts fund holdings in any one entity to 5%. Maybe it’s time to reduce the limit to 1%, he suggests. ■


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### Greater disclosure freedom emerges from no-action letter but beware carte blanche

A recent SEC no-action letter removes some requirements when you pay someone to solicit investors for a fund you manage. However, some caution you shouldn’t read the letter as erasing all risks tied to disclosing these payments.

We first told you about the letter in July ([IA Week](#) , July 21, 2008). It’s worth taking a deeper look at the

no-action letter because it can be misinterpreted. Also, take note the SEC has released a revised version of the [letter](#) , apparently to correct minor typos.

The SEC’s no-action letter was prompted by correspondence from [Michael Butowsky](#) , a partner with **Mayer Brown** in New York. Butowsky tells **IA Week** he wanted to raise the issue because too many clients were getting dinged on exams for violating Advisers Act rule 206(4)-3 (the cash solicitation rule) for failing to disclose payments made by the advisory firm to broker-dealers and other solicitors to direct investors to funds managed by the adviser.

He felt examiners were improperly applying the rule, and the SEC’s no-action letter basically agreed with his view. The upshot means advisers no longer have to get a signed disclosure statement from investors in these situations, relieving you of certain books and records requirements, says **Matthew Eisenberg**, partner, **Finn Dixon & Herling** in Stamford, Conn.

Rather than having the type of disclosure in these cases defined by the SEC, it’s now up to you, says Butowsky. But don’t equate this with laissez-faire. “That would be a real mistake for people ... to say ‘we don’t really have to worry about this stuff anymore,’” says Butowsky.

Eisenberg agrees. Examiners could still visit and determine your level of disclosure wasn’t proper enough, citing rule 206 or other anti-fraud provisions of the Act.

Some advisers may play it safe and simply continue their same level of disclosure, despite the no-action letter, relates Butowsky. He emphasizes though that each individual circumstance would dictate the necessary level of disclosure. And examiners shouldn’t be citing 206(4)-3 for these deficiencies – thanks to the no-action letter.

You should continue to be vigilant in how you complete Section 13 (additional compensation) in Form ADV, Part II.

Also, be aware that the no-action letter covers only the situation cited – privately offered investment funds managed by a registered adviser. Solicitations outside this realm may still involve the cash solicitation rule. For example, if the solicitation leads to a managed account, the rule could be implicated, says Eisenberg.

He adds the no-action letter doesn’t change the need for the solicitor to be a registered broker-dealer and a FINRA member. The letter is especially relevant because there are more third-party marketers these days and performance pressures make it difficult for managers to raise enough capital for their business, Eisenberg points out. ■

Part 1 of series

## Strategies to get a grip through this market's wild, roller coaster ride

Admit it. Lately you've been fighting the urge to glance at how the market's doing, right, afraid of ever-worsening red numbers?

Some say you may never find a better time to thrive. "Now is your opportunity," says **Amy Lynch**, president, **Frontline Compliance** in Alexandria, Va., of smaller advisory firms. Get busy on the phone calling investors and "making money while the bigger guys are sleeping or shackled," she says. "You can literally steal business from the other guys right now."

Improve your outreach to clients and you'll see a spike in referrals, agrees **Ray Sclafani**, president of **ClientWise** in Tarrytown, N.Y. He tells of one adviser who has been meeting with clients lately to go over their portfolio given the market flux and using the occasion to instruct them to refer any friends who feel uncertain about this market. The adviser has picked up gobs of new prospects, Sclafani adds.

Once you have the customers, what do you do with them? Calm them. "You have to just convince them to ... stay the course and things will be fine," says **Patrick Dennis**, principal & managing director with **Oyster Consulting** in Glen Allen, Va.

"We've got a responsibility as advisers to help people to" not panic but to make the right decisions, says **William Brown**, who runs his **Family Legacy** firm from Greenville, S.C. You can't do this if your emotions are frayed, he says. "The thing you really can control is your emotions."

Panic does not a good investment strategy make. Remind clients that on the other side of every sale sits an eager buyer, says Brown.

**TIP:** Create an at-risk client list, suggests Sclafani. Put on it those clients who may be thinking of pulling out of the market, who are frightened and those who potentially may leave your firm. Contact these folks first.

"This is a time to really re-connect with clients around the financial plan," he says. Reassess their goals given this market. Advisers who would be challenged to do this call "into question how many clients can they actually manage."

### 'Survey says...'

A new survey by the **Certified Financial Planner Board of Standards** (CFP) finds two thirds of financial planners have seen an increase in potential clients "as the

turbulence with the economy has increased over the past several weeks."

The CFP survey of more than 5,000 planners reports 78% are standing firm with their strategies, 57% are reviewing allocations, 48% are reviewing financial goals, 45% are moving to lower risk investments, 40% are taking advantage of lower stock prices, and 37% are rebalancing portfolios.

**Editor's note:** Next week we'll look at some of the lessons from the failure of **Lehman Brothers**. ■

## A plunging market could force some firms to de-register

If your total AUM hover around \$25 million – and you're an SEC registered adviser – today's bear market may hold implications for your firm beyond losses and gains. Your registration status could be at risk.

First, exhale, in that you probably don't have to worry about this until next March. That's when most firms will be sending the SEC their annual Form ADV update. SEC rules require RIAs to calculate "the current market value" of their assets "within 90 days prior to the date of filing," or roughly three months from the end of the fiscal year. For most advisers, their fiscal year ends Dec. 31.

The bulk of assets managed by advisers are held by firms that far exceed the \$25 million plateau.

If your firm straddles that magic line, though, figure your AUM using the same method you use to report account values to clients or to calculate fees for investment advisory services. If your assets happen to dip below the threshold at any time during the 90-day reporting period, this doesn't mean you must de-register. Should the market turnaround the next day and take you above the threshold, you can report that figure and stay registered.

Should all signs be pointing south of \$25 million, you probably would opt for the "partial withdrawal" – which would leave you registered in your state – versus a "full withdrawal," which would remove your registration from the SEC and the states.

### The rules

Check box 12 under Item 2.A on the Form ADV to indicate your firm has slipped below \$25 million in AUM. This starts the clock for you to withdraw your SEC registration within 180 days of the end of your fiscal year. Use Form ADV-W. Until you complete and send in this form, you would still be subjected to SEC regulation. ■

## Restrictions reduced on resale of unregistered securities

In case you missed it, the SEC earlier this year cut the time to six months from 12 months for resale of unregistered securities. The change was part of a liberalization of its [rule 144](#) that removed the need to file certain forms with the Commission, volume restrictions and the requirement to sell through a broker.

The agency took the action as an acknowledgement that today's financial world works quicker and to make the raising of capital more efficient, says [Tom Reddy](#), partner, **Bingham McCutchen** in San Francisco. The only remaining requirement to satisfy the SEC safe harbor – after the six month resale-hold – is that the company must be current in its SEC filings.

If it takes six months to get a security registered via the SEC, then the rule change effectively provides the same liquidity for an unregistered security as you would get with a registered one, points out [Darren DeStefano](#), partner with **Cooley Godward Kronish** in Washington.

**TIP:** When buying securities for client accounts or your own, be aware of whether there are any resale restrictions, says [Matthew Eisenberg](#), partner, **Finn Dixon & Herling**, Stamford, Conn. ■

## SEC seeks to bar adviser caught in fraud related to mortgage mess

Claims of fraud tied to collateralized mortgage obligations have persisted for months and the SEC is building on a successful case against a former registered investment adviser found liable for fraud related to CMOs by attempting to bar him permanently from the industry.

[Don Warner Reinhard](#) ran **Magnolia Capital Advisors** from 1999-2003. The SEC last week attempted to permanently bar him from the securities business for the fraud. An earlier [lawsuit](#) found Reinhard:

- Misrepresented “the safety of the highly leveraged CMOs he purchased for his clients’ accounts” in a hedge fund he controlled.
- Failed to tell his clients – or in filings with the SEC – that Florida’s Department of Insurance was suing him over the CMO investments and fraud.
- Parked the CMO investments in the accounts of

third parties “to artificially increase the equity in certain brokerage accounts and avoid margin calls.”

- Provided false quarterly accounts to investors, who lost more than \$6 million.
- Told one client, a 78-year-old retired dental hygienist, that the CMOs were government-backed bonds, among other alleged bogus claims.

The case started with a for-cause exam by the SEC, and then a referral to enforcement. In December, Reinhard should learn his disgorgement and civil penalties. Reinhard didn't respond to our requests for comment. ■

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