October 1, 2014

Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Proposes Extending Temporary Rule Regarding Adviser Principal Trades

On August 12, 2014, the SEC proposed an amendment to Rule 206(3)-3T to extend the Rule's expiration date by two years until December 31, 2016. The temporary Rule provides an alternative method for investment advisers, who are also broker-dealers, to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. On December 20, 2012, the SEC extended Rule 206(3)-3T until December 31, 2014. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC proposed no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension would provide adequate protection to advisory clients while the SEC continues to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.

SEC Adopts Money Market Fund Rule Amendments

On July 23, 2014, on a 3-2 vote, the SEC adopted amendments to certain rules under the 1940 Act, including Rule 2a-7, that govern money market funds. According to the SEC, the rule amendments seek to: (1) limit money market funds' susceptibility to heavy redemptions during periods of market stress, (2) improve money market funds' ability to deal with potential contagion from heavy redemptions, (3) increase risk transparency in money market funds, and (4) preserve, to the extent possible, the benefits of money market funds for investors. The primary rule changes include the requirement for certain money market funds to operate using a floating NAV rather than a stable NAV, and the ability of money market funds to impose liquidity fees and redemption gates in certain circumstances to stem redemptions. In addition, the SEC adopted other rule and form amendments applicable to money market funds, including enhanced diversification and disclosure requirements.

Floating NAV

The rule amendments require institutional prime money market funds (i.e., those that primarily invest in corporate debt securities) and institutional municipal money market funds (i.e., those that primarily invest in tax-exempt municipal securities) to operate using a floating NAV. The amendments eliminate the valuation exemptions for these types of funds that allowed the use of amortized cost to value portfolio securities and/or permitted a fund to round its NAV to the nearest penny in order to maintain a stable share price (generally $1.00). Institutional prime money market funds and institutional municipal money market funds will be required to sell and redeem shares based on the current market value of their portfolio securities. Under the rule amendments, these funds also must round their share prices and transact in fund shares to four decimal places in the case of a $1.0000 share price or an equivalent level of accuracy for funds with a different share price (e.g., $10.000).

The floating NAV requirement does not apply to government money market funds or retail money market funds. Government money market funds are defined under the rule amendments as those funds that invest at least 99.5% of their total assets in government securities, cash and/or repurchase agreements that are collateralized by cash or government securities. (Government money market funds currently are able to invest up to 20% of total assets in non-government assets.) Retail money market funds are defined as those funds that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. In the adopting release, the SEC recognized that in order to qualify as a retail money market fund, funds that currently have both retail and institutional investors would need to reorganize into separate retail and institutional money market funds or otherwise involuntarily redeem certain investors. To help facilitate these actions, the SEC, in the adopting release, provided exemptive relief from Sections 17(a), 18 and 22(e) of the 1940 Act, which might otherwise prohibit the reorganizations or redemptions, subject certain board determinations and notice requirements.

Liquidity Fees and Redemption Gates

The final rule amendments allow liquidity fees and/or redemption gates in certain circumstances for all non-government money market funds as compared to the proposed rule amendments which would have required them. Although government money market funds are not subject to the new liquidity fees and redemption gates provisions, these funds could voluntarily opt into them if previously disclosed to investors.

- If a money market fund's weekly liquid assets fall below 30% of its total assets, the fund may impose a liquidity fee of up to 2% on all redemptions upon a determination by the fund's board of directors (including a majority of its independent directors) that imposing such a fee is in the best interests of the fund.
- If a money market fund's weekly liquid assets fall below 30% of its total assets, the fund may suspend redemptions (impose a redemption gate) for up to 10 business days in a rolling 90-day period upon a determination by the fund's board of directors (including a majority of its independent directors) that imposing a redemption gate is in the best interests of the fund.
- If a money market fund's weekly liquid assets fall below 10% of its total assets, the fund is required to impose a liquidity fee of 1% on all redemptions unless the fund's board of directors (including a majority of its independent directors) determines that such a fee is not in the best interests of the fund or determines that a lower or higher fee (not to exceed 2%) would be in the best interests of the fund.
- If a money market fund's weekly liquid assets fall below 10% of its total assets, the fund's board of directors (including a majority of its independent directors) may permanently suspend redemptions and proceed to liquidate the fund.

Weekly liquid assets generally include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, and securities that convert into cash within one week.

Enhanced Disclosure, Diversification and Stress Testing

The rule amendments provide several changes to money market fund disclosure requirements. Advertisements and summary prospectuses must include specific disclosure regarding risks associated with a money market fund, the use of liquidity fees or redemption gates, the use of a stable NAV or a floating NAV, as applicable, and sponsor support of the fund. Websites of money market funds must disclose, on a daily basis, the levels of daily and weekly liquid assets, net inflows and outflows, market-based NAVs per share, the use of any liquidity fees and redemption gates and any sponsor support. Form N-MFP was also amended to add new reporting requirements and to eliminate the 60-day delay on the public availability of the information filed. Finally, the rule amendments require money market funds to promptly disclose certain significant events on new Form N-CR, including security defaults, sponsor support, the use of liquidity fees or redemption gates and, for retail and government money market funds, a decline in the fund's market-based NAV below $0.9975 or its equivalent for funds with a different share price.

The rule amendments also change the investment diversification requirements for money market funds. Currently, money market funds generally must limit their investments in (1) securities of any one issuer to no more than 5% of fund assets and (2) securities subject to a demand feature or a guarantee to no more than 10% of fund assets from any one provider; however, as much as 25% of the value of securities held in a money market fund's portfolio may be subject to guarantees or demand features from one institution (25% basket). The rule amendments require money market funds to treat certain entities affiliated with each other as single issuers for purposes of complying with the 5% diversification limit. The rule amendments also require funds to treat the sponsors of asset-backed securities as guarantors subject to the 10% diversification limit, unless the board of directors makes certain determinations that the fund is not relying on the sponsor's financial strength or credit support when determining the security's quality or liquidity. Finally, the rule amendments eliminate the 25% basket for all money market funds except municipal money market funds, which may now only invest up to 15% in securities subject to guarantees or demand features from one institution.

The rule amendments also enhance the stress testing requirements applicable to money market funds. The rule amendments require money market funds to test their ability to maintain weekly liquid assets of at least 10% and to minimize principal volatility (and, for stable NAV money market funds, the ability to maintain a stable share price) in response to certain prescribed scenarios.

Tax Implications

In connection with the SEC's adoption of the money market fund rule amendments, the IRS adopted a revenue procedure exempting floating NAV money market funds from the wash sale rules. In addition, the IRS proposed regulations to provide a simplified method of accounting for gains and losses on shares of floating NAV money market funds.

Compliance Dates

The new rule amendments become effective on October 14, 2014. The compliance date for the floating NAV, liquidity fees and redemption gates amendments is October 14, 2016. The compliance date for the diversification, disclosure and stress testing amendments is April 14, 2016. The compliance date for reports on new Form N-CR is July 14, 2015.

SEC Includes Valuation Guidance in Money Market Fund Rule Release

In the adopting release for the recent money market fund rule amendments, the SEC provided guidance for the valuation of short-term debt securities and thinly-traded holdings that is applicable to all registered investment companies and business development companies. The SEC's guidance focused on two issues: amortized cost valuation and the use of evaluated prices from pricing services. The guidance states that, in order to use amortized cost to value a security (including debt securities with remaining maturities of 60 days or less), a fund must be able to reasonably conclude *each time* it makes a valuation determination that the amortized cost is *approximately the same* as the fair value of the security as determined using market-based factors. Accordingly, the guidance notes that it would not be appropriate to evaluate the use of amortized cost on just a quarterly basis or when preparing financial statements.

The SEC also reminded directors that a fund board "has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security." The SEC's guidance includes the following matters for fund boards to consider with respect to the use of evaluated prices from a pricing service to assist in determining fair value:

- the inputs, methods, models and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models and assumptions are affected (if at all) as market conditions change;
- the quality of the evaluated prices provided by the pricing service and the time at which the pricing service determines its evaluated prices as compared to when the fund calculates its net asset value; and

- the appropriateness of using evaluated prices provided by a pricing service as fair values for the fund's portfolio securities where the board does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions.

SEC Re-Proposes Amendments to Remove References to Credit Ratings from Money Market Fund Rule

On July 23, 2014, the SEC re-proposed, with changes, amendments to Rule 2a-7 under the 1940 Act and Form N-MFP that were initially proposed in March 2011 and intended to comply with the requirements of the Dodd-Frank Act that any references to credit ratings in the SEC's regulations be removed and replaced with other standards of creditworthiness. The SEC also proposed an additional amendment to the diversification requirements under Rule 2a-7.

The re-proposed amendments to remove credit ratings would affect the following elements of Rule 2a-7: (1) determination of whether a security is an eligible security and the distinction between first and second tier securities, (2) credit quality standards for securities with a conditional demand feature, (3) requirements for monitoring securities for ratings downgrades and other credit events and (4) stress testing.

As re-proposed, the definition of "eligible security" would be amended to remove references to credit ratings provided by nationally recognized statistical rating organizations (NRSROs). Under the proposed rule amendments, an eligible security would be a security with a remaining maturity of 397 calendar days or less that a money market fund's board of directors (or its delegate) determines presents minimal credit risks, which determination includes a finding that the security's issuer has an exceptionally strong capacity to meet its short-term obligations. This single standard would eliminate the current distinction between first and second tier securities under Rule 2a-7 and therefore the SEC also is proposing to remove the current prohibition on money market funds from investing more than 3% of their assets in second tier securities. However, the SEC stated in the proposing release its belief that securities rated in the third-highest rating category would not satisfy the proposed "exceptionally strong capacity" standard and therefore would not be eligible securities under Rule 2a-7.

With respect to securities with a conditional demand feature, the re-proposed rule amendments would replace references to NRSRO ratings with a requirement that a money market fund's board of directors (or its delegate) evaluate the long-term risk of the underlying security and determine that it "has a very strong capacity for payment of its financial commitments." Under the re-proposed rule amendments, the current requirement for a money market fund's board of directors (or its delegate) to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks would be replaced with the requirement that a money market fund adopt written procedures requiring the fund's adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks. Finally, the re-proposed rule amendments would remove references to credit rating downgrades from the "stress test" requirements by replacing the hypothetical event of a downgrade with a requirement that money market funds stress test for an event indicating or evidencing credit deterioration of particular portfolio security positions. The proposed rule amendments would describe the types of hypothetical events money market funds should stress test for, including downgrades or defaults as examples.

The SEC also re-proposed amendments to Form N-MFP to require money market funds to disclose, for each portfolio security, (1) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO's services, as well as the name of the agency providing the rating and (2) any other NRSRO rating that the fund's board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.

Finally, the SEC proposed amendments to the diversification requirements under Rule 2a-7 which would eliminate an exclusion that is currently available for securities subject to guarantees issued by a non-controlled person (i.e., a person not controlling, controlled by or under common control with the issuer of the security subject to the guarantee).

Currently, under Rule 2a-7, money market funds are not allowed to invest more than 5% of their total assets in any one issuer. They also must limit investments in securities subject to a demand feature or a guarantee to no more than 10% of their total assets from any one provider. Consequently, although Rule 2a-7 requires diversification with respect to providers of guarantees or demand features, it does not require diversification with respect to issuers of securities that are guaranteed by a non-controlled person. The proposed amendment would eliminate this exclusion by requiring money market funds that invest in securities subject to guarantees to comply with the 5% diversification requirement for issuers.

Comments on the proposed rule amendments are due by October 14, 2014.

FinCEN Proposes Anti-Money Laundering Rules

On July 23, 2014, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a Notice of Proposed Rulemaking that would amend existing Bank Secrecy Act regulations with respect to customer due diligence (CDD) requirements for certain covered financial institutions, including mutual funds, brokers or dealers in securities and futures commission merchants and introducing brokers in commodities. The proposed rules would formalize certain CDD requirements and also require that covered financial institutions "identify and verify the beneficial owners of legal entity customers." FinCEN's proposal includes a standard certification form that covered financial institutions would be required to use for documenting the beneficial ownership of their legal entity customers. An individual may qualify as a "beneficial owner" of a legal entity customer if the individual either (1) owns 25% or more of the equity interests of the entity, or (2) has significant management responsibilities within the entity. As proposed, covered financial institutions would be exempted from identifying the beneficial owners of an intermediary's underlying clients if the covered financial institution has no customer identification program obligation with respect to those underlying clients.

Comments on the Notice of Proposed Rulemaking are due by October 3, 2014.

Litigation and Enforcement Actions

SEC Settles Charges Against Barclays Capital for Compliance Failures After Acquisition of Lehman's Advisory Business

On September 23, 2014, the SEC settled charges against Barclays Capital Inc. for failing to maintain an adequate internal compliance system after it acquired the advisory business of Lehman Brothers in September 2008. According to the SEC's order, Barclays Capital failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and failed to maintain certain required books and records. The SEC found that these deficiencies contributed to various violations of the Advisers Act by Barclays Capital, including executing more than 1,500 principal transactions with clients without making the required written disclosures or obtaining client consent; charging commissions and fees that were inconsistent with its disclosures to clients; and violating the custody rule under the Advisers Act. Barclays Capital agreed to pay a $15 million penalty and retain an independent compliance consultant to settle the charges.

SEC Settles Charges Against Investment Advisory Firm for Undisclosed Principal Transactions and Misleading Performance Advertisements

On September 18, 2014, the SEC settled charges against Strategic Capital Group, LLC and its CEO, N. Gary Price, for engaging in hundreds of principal transactions through its affiliated broker-dealer without informing clients or obtaining their consent and for distributing false and misleading advertisements to investors. According to the SEC's order, Strategic Capital engaged in more than 1,100 principal transactions through its broker-dealer affiliate without making the required disclosures to clients or obtaining consent. The SEC found that Strategic Capital also failed to seek best execution for the transactions it executed through its broker-dealer affiliate, and that Mr. Price signed regulatory filings incorrectly stating that Strategic Capital did not engage in principal transactions. The SEC also found that Strategic Capital distributed false and misleading advertisements to prospective investors, with one advertisement failing to disclose that the portrayed results were partially based on returns of an index rather than actual, historical returns, and the other advertisement failing to disclose that the results portrayed were gross of fees.

The SEC's order found that Strategic Capital violated the antifraud, principal transactions, advertising, compliance and reporting provisions of the Advisers Act. The SEC's order also found that Mr. Price caused Strategic Capital's violations of the compliance and reporting provisions of the Advisers Act. Strategic Capital agreed to pay nearly $600,000 to settle the SEC's charges and Mr. Price agreed to pay a $50,000 penalty. Strategic Capital also agreed to retain an independent compliance consultant.

SEC Settles Multiple Enforcement Actions for Failure to Timely File Reports of Beneficial Ownership

On September 10, 2014, the SEC settled charges against a number of directors and officers, companies and significant stockholders for failing to timely file reports of beneficial ownership. The SEC used computer algorithms and quantitative data sources to identify delinquent filers of Section 16(a) reports (Forms 3, 4 and 5) and Schedules 13D and 13G. The SEC charged 14 individuals serving as public company directors and/or executive officers, five individual beneficial owners of publicly traded securities, 10 investment firms and seven public companies. Thirty-five out of the 36 persons and entities charged agreed to settle (without admitting fault) and paid penalties ranging from $25,000 to $375,000. While the SEC's actions targeted individuals and companies "with especially high rates of filing deficiencies," the SEC warned that "[o]fficers, directors, major shareholders, and issuers should all take note: inadvertence is no defense to filing violations, and we will vigorously police these sorts of violations through streamlined actions." In the cases of the sanctioned directors and officers, many had dozens of unreported or late-reported transactions spanning time periods, in some cases, of over two years. The SEC emphasized that the ultimate legal responsibility for filing beneficial-ownership reports rests with the individual. Directors and officers were not excused from their violations simply because the company where they serve as officer or director failed to make timely filings on their behalf or because brokers failed to provide timely notices of the insiders' market purchases or sales. With respect to companies, while the SEC encourages companies to assist their insiders with their Section 16(a) reporting obligations, companies that do so may become liable for causing violations by their insiders where the companies act negligently in the performance of those tasks. In addition, companies may become liable for inaccurate proxy statement disclosure if statements about insiders' Section 16(a) report filings are incorrect.

SEC Charges Investment Advisory Firm with Failure to Disclose Conflict of Interest to Clients

On September 2, 2014, the SEC brought charges against The Robare Group Ltd. and its owners Mark Robare and Jack Jones, Jr. for recommending that clients invest in particular funds without disclosing that the firm was receiving compensation from the broker offering the funds. According to the SEC's order, in 2004, Robare Group entered into an agreement with a broker that provided for the broker to compensate Robare Group for investing client assets in certain funds on the broker's platform; however, the SEC alleges that Robare Group did not disclose this compensation arrangement to clients through its Form ADV or otherwise until 2011. The SEC further alleges that, when Robare Group did revise its Form ADV in December 2011 to disclose the compensation arrangement, the disclosures were inadequate. The SEC's order states that Messrs. Robare and Jones, Jr. approved Robare Group's Form ADV filings knowing that they failed to disclose or failed to adequately disclose the compensation arrangement and the related conflict of interest.

The SEC's order alleges that Robare Group and Mr. Robare willfully violated Sections 206(1) and 206(2) of the Advisers Act, and that Mr. Jones, Jr. aided and abetted these violations. The SEC further alleges that the Robare Group and Messrs. Robare and Jones, Jr. each willfully violated Section 207 of the Advisers Act.

District Court Grants Summary Judgment and Dismisses Case Regarding Insider Trading Prohibitions and Mutual Fund Redemptions

On August 29, 2014, the U.S. District Court for the Eastern District of Wisconsin granted Jilaine H. Bauer's motion for summary judgment in *Securities and Exchange Commission v. Bauer* and dismissed the SEC's case, determining that an insider trading claim brought under a "misappropriation theory" was not properly presented to the court and that a "misappropriation theory" did not properly apply to the conduct of Ms. Bauer, who at all relevant times was a corporate insider.

In the fall of 2000, Ms. Bauer served as general counsel, chief compliance officer and chairperson of the pricing committee for Heartland Advisors, Inc. (HAI), and as vice president and secretary of Heartland Group, Inc. (HGI), an open-end fund. HAI was the investment adviser, principal underwriter and distributor for the HGI mutual funds, including the Short Duration Fund and the High Yield Fund (the Funds). Beginning in 1999 and continuing through October 2000, the Funds experienced substantial net redemptions, resulting in significant decreases in NAV and increased illiquidity. In addition, several of the Funds' portfolio securities had defaulted or were in danger of default. In order to generate the cash required to meet redemption demands, the Funds began selling off securities at discounted prices. Ms. Bauer redeemed all of her shares in the Short Duration Fund on October 3, 2000. Ten days later, HAI's pricing committee instituted across-the-board "haircuts" on the Funds' securities, resulting in NAV decreases of 44.02% and 69.41% for the two Funds, which entered receivership five months later.

On December 11, 2003, the SEC charged Ms. Bauer with insider trading, and on May 25, 2011, the district court granted summary judgment to the SEC under the "classical theory" of insider trading, which "targets a corporate insider's breach of duty to shareholders with whom the insider transacts." In order to expedite the entry of judgment against Ms. Bauer on the insider trading claim, the SEC filed an unopposed voluntary motion to dismiss with prejudice all claims against Ms. Bauer other than the counts of insider trading discussed in the May 25, 2011 opinion. The district court granted the SEC's voluntary motion to dismiss on September 20, 2011.

On appeal to the U.S. Court of Appeals for the Seventh Circuit, Ms. Bauer argued that the "classical theory" is inapplicable to mutual fund redemptions because the trading counterparty—the mutual fund itself—is inherently fully informed and "cannot be duped through nondisclosure." The SEC abandoned the "classical theory" on appeal, instead arguing that Ms. Bauer was liable under the "misappropriation theory" of insider trading, whereby the disclosure obligation "runs to the source of the information" rather than the trading counterparty.

On July 22, 2013, the Seventh Circuit reversed the district court's ruling and remanded for further proceedings to consider the novel issue of whether and how the "misappropriation theory" of insider trading applies to mutual fund redemptions. In reversing the district court's order of summary judgment, the Seventh Circuit found that the lower court did not "weigh the novelty of the SEC's claims in the mutual fund context" because the SEC had not asserted the "misappropriation theory" of insider trading at the district court level. The Seventh Circuit remanded for further proceedings to consider the applicability of the "misappropriation theory" to Ms. Bauer's redemptions and to resolve questions of fact related to the materiality of Ms. Bauer's non-public information and whether Ms. Bauer acted with scienter.

On remand, the district court granted summary judgment to Ms. Bauer and dismissed the remainder of the SEC's insider trading case. In granting summary judgment, the district court noted that the SEC never properly raised the "misappropriation theory" before the court, and that, as a general matter, any theory not raised before the district court is deemed waived or forfeited. In addition, the district court noted that the "misappropriation theory" was different from the insider trading claim discussed in the court's May 25, 2011 opinion and, as a result, any claim based on such theory would have been dismissed with prejudice pursuant to the SEC's voluntary motion to dismiss granted on September 20, 2011. Moreover, the district court refused to extend the "misappropriation theory" of insider trading to Ms. Bauer given her status as an officer of the investment adviser to the Funds at all relevant times. The district court could find no precedent supporting the extension of the "misappropriation theory," which has generally been interpreted to apply only to conduct by corporate outsiders, to a corporate insider and stated that the SEC did not sufficiently explain "how an officer at a mutual fund investment adviser can be fairly considered a corporate 'outsider' given the investment adviser's deeply entwined role as sponsor and external manager of the fund."

FINRA Fines Merrill Lynch for Failing to Identify and Apply Mutual Fund Sales Charge Waivers Available for Retirement Accounts and Charitable Organizations

On June 16, 2014, Merrill Lynch, Pierce, Fenner & Smith Incorporated entered into a Letter of Acceptance, Waiver and Consent with the Financial Industry Regulatory Authority to settle alleged rule violations in connection with the firm's failure to apply mutual fund sales charge waivers at various times since at least January 2006 for approximately 41,000 small business retirement plan accounts and approximately 6,800 accounts of charitable organizations and 403(b) retirement accounts available to ministers and employees of public schools. Although most of the mutual funds available on Merrill Lynch's platform offered waivers of front-end sales charges for the eligible retirement plan accounts and charities and disclosed those waivers in their prospectuses, FINRA alleged that Merrill Lynch treated the eligible accounts in the same manner as non-retirement or ordinary retail customer accounts and, as a result, the eligible accounts either unnecessarily paid sales charges when purchasing shares, or purchased other share classes that subjected them to higher ongoing fees and expenses.

With respect to the small business retirement plan accounts, FINRA alleged that certain supervisory, compliance and legal personnel at Merrill Lynch became aware in 2006 that such accounts were being disadvantaged by not purchasing the most favorable Class A shares with sales charge waivers, but the firm elected not to notify its financial advisers and, in fact, allowed its financial advisers to sell Class A shares with front-end sales charges or more costly Class B and Class C shares to these accounts until 2011. FINRA also alleged that Merrill Lynch's policies and procedures for mutual fund purchases on its retail brokerage platform, where the small business retirement plan accounts at issue were maintained, were not designed to adequately supervise the administration of mutual fund sales charge waivers for such accounts. Merrill Lynch formed an internal task force to evaluate the small business retirement plan account problems and, after determining that the firm's systems and procedures were not designed to systematically identify and provide mutual fund Class A sales charge waivers to such eligible accounts, recommended that the firm develop and implement technological improvements that would permit the firm to more readily identify customer accounts eligible for sales charge waivers. However, FINRA alleged that development work on the improvements was never fully funded or implemented. In addition, FINRA alleged that Merrill Lynch advised its sales force in October 2010 that financial advisers were responsible for determining whether a sales charge waiver was available pursuant to mutual fund prospectuses, but did not provide its financial advisers or supervisors with any other guidance or training to determine whether accounts qualified for such waivers. Similarly, according to FINRA's allegations, Merrill Lynch solely relied upon its financial advisers to determine opportunities for 403(b) retirement accounts and accounts for charitable organizations to purchase shares with sales charge waivers, but did not have adequate written policies or procedures to help financial advisers or supervisors determine the eligibility of such accounts, and did not have controls to detect instances in which sales charge waivers should have been applied.

FINRA concluded that Merrill Lynch failed to establish and maintain an adequate supervisory system and written procedures to identify Class A mutual fund sales charge waivers in fund prospectuses, failed to adequately notify and train its financial advisers regarding mutual fund sales waiver eligibility requirements, and failed to have an adequate supervisory system to ensure that eligible accounts purchased Class A shares with sales charge waivers, resulting in violations of NASD Rules 3010 and 2110 and FINRA Rule 2010. Merrill Lynch consented to a censure and a fine of $8 million and agreed to pay $24.4 million in restitution to affected customers, in addition to $64.8 million the firm already paid.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.

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Investment Services Group

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