

BDQUARTERLY

“Rule G-37 serves a compelling government interest and is essential to diminish pay-to-play practices in the municipal securities market.”

— SEC opinion issued by Chairman Christopher Cox, Commissioner Kathleen Casey and former Commission Annette Nazareth dtd. November 5, 2007

Political Contributions Can Affect More than the Candidates

Background

During an election year, many investment professionals tend to increase their political contributions to candidates and entities affiliated with their favored political party. Political contributions to the presidential candidates receive a tremendous amount of scrutiny and attention. For firms that engage in a municipal securities business,¹ such scrutiny comes not only from the press or independent watch dog groups, but also from the MSRB.

Nearly 15 years after the adoption of MSRB Rule G-37, many broker-dealers and municipal finance

professionals continue to struggle with the various requirements outlined in the rule. Generally, Rule G-37 prohibits brokers, dealers and municipal securities dealers (“dealers”) from engaging in municipal securities business with issuers for a two-year period if certain political contributions have been made to officials of such issuers by the dealer or associated municipal finance professionals. The rule also prohibits dealers and their municipal finance professionals from soliciting any person, including affiliated entities or political action committees, from making any contribution, or coordinating any contributions, to an official of an issuer with which the dealer is engaged or seeks to engage in business. Rule G-37 also contains provisions for reporting to the MSRB contributions to officials of issuers made by dealers and their associated municipal finance professionals. The goal of Rule G-37 is to assist in dissolving the connection between contributions and the awarding of municipal securities business.

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1— MSRB Rule G-37(g)(vii) defines “municipal securities business” to include (A) the purchase of a primary offering of municipal securities from the issuer on other than a competitive bid basis (e.g., negotiated underwriting); (B) the offer or sale of a primary offering of municipal securities on behalf of any issuer (e.g., private placement); (C) the provision of financial advisory or consultant services to or on behalf of an issuer with respect to a primary offering of municipal securities in which the dealer was chosen to provide such services on other than a competitive bid basis; or (D) the provision of remarketing agent services to or on behalf of an issuer with respect to a primary offering of municipal securities in which the dealer was chosen to provide such services on other than a competitive bid basis.

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Contribution Regulations

A contribution in excess of \$250 made by a dealer or its municipal finance professionals to an official of an issuer prohibits the dealer from engaging in municipal securities business for two years after the contribution is made to that issuer. Additionally, Form G-37 must be submitted to the MSRB for a calendar quarter if either of the following occurs:

- Reportable political contributions or payments to political parties were made during the reporting period, unless the dealer has previously submitted Form G-37x and the submission remains effective; or
- The dealer engaged in municipal securities business during the reporting period.

Form G-37 must be submitted by the last calendar day of the month following each calendar quarter (i.e., January 31, April 30, July 31 and October 31 of each year). Form G-37 may be submitted to the MSRB either electronically through the Electronic G-37 System or in paper form.²

Monitoring Political Contributions

Dealers that engage in municipal securities business are required to establish and maintain written supervisory procedures that enable the compliance function to supervise the conduct of the municipal securities activities of the dealer and its associated municipal finance professionals in complying with the MSRB rules. MSRB Rule G-27(c) requires dealers to implement procedures that must include, at a minimum, the following elements:

- Method used by the designated principal to supervise the municipal securities activities of associated municipal finance professionals;
- Periodic reviews by the designated principal; and

²— Electronic submission of Form G-37 requires pre-registration with the MSRB to use the eG-37 System by completing the registration form available at www.msrb.org.

- Maintenance and preservation of the required books and records.³

Principals/supervisors may also wish to consider adopting the following best practice to monitor political contributions:

- Require each municipal finance professional, as defined in MSRB Rule G-37(g)(iv), to read and attest to having understood the dealer's political contribution policy and procedures quarterly;
- Require each municipal finance professional to obtain pre-clearance from compliance on all contribution request, regardless of the amount;
- Require each municipal finance professional to annually disclose all political contributions made during the preceding year, either directly or indirectly (e.g., contribution made by a check drawn on a joint account, which is owned by the municipal finance professional and another person.); and
- Screen all newly hired municipal finance professionals to assure they have not made any political contributions in excess of \$250, which may hinder the dealer from engaging in municipal securities activities for two years.

Exemptions and Acceptable Practice Relating to Political Contributions

As noted above, aggregate contributions of less than \$250 made to officials of issuers by municipal finance professionals are not required to be reported to MSRB.

Additionally, if a dealer were to discover that one of its municipal finance professionals (CONTINUED)

³— Rule G-8 requires that every broker, dealer, or municipal securities dealer shall make and keep current, among other records, records reflecting the contributions, direct or indirect, to officials of an issuer made by each municipal finance professional.

Rule G-9 requires that every broker, dealer, or municipal securities dealer preserve records required to be kept by Rule G-8 for a period of not less than six years.

had previously made a contribution greater than \$250, though the dealer may potentially be in violation of untimely reporting of Form G-37, the dealer may still engage in competitive underwritings or competitive remarketing services for the issuers.

Recent Enforcement Actions Relating to G-37 Violations

MSRB rules are enforced by FINRA in the case of broker-dealers and by the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Comptroller of the Currency in the case of banks. A review of FINRA's monetary sanctions outlined in the "FINRA Sanction Guidelines" indicates that fines related to violation of political contribution regulations range from \$10,000 to \$50,000 for the dealer and separately for the responsible individuals. Additionally, dealers cited for such violations have historically been forced to disgorge potential profits. Most critical, however, is the resulting reputation damage, which may far exceed the monetary sanctions.

Following are some recent regulatory actions related to political contributions:

- On May 16, 2008, FINRA censured and fined Piper Jaffray & Company \$25,000, while forcing the dealer to disgorge \$260,157 in profits, for two municipal securities transactions the dealer assisted in underwriting in Minnesota during a two-year prohibition on doing business with Minnesota issuers. The prohibition had been triggered by political contributions by a former vice chairman made to the state's governor. The findings also stated that the firm failed to maintain a supervisory system to adequately monitor the political contributions of its municipal finance professionals to ensure compliance with MSRB rules.⁴
- On January 31, 2006, FINRA censured and imposed a \$100,000 fine on Berean Capital Inc.,

now part of Jackson Securities, and a top official, for contributing to the St. Louis comptroller and then underwriting notes for the city, while failing to report several political contributions made to the issuer officials.⁵

- On December 12, 2005, the Securities and Exchange Commission announced the settlement of administrative proceedings against CIBC World Markets Corporation ("CIBC") and three employees for violation of MSRB Rule G-37. The SEC found that CIBC performed securities work for the State of California during the two years after CIBC contributed \$10,000 to former California Governor Gray Davis's reelection campaign. The Commission also found that CIBC violated related MSRB rules by failing to disclose in its periodic reports to the MSRB, and to maintain the requisite records of, CIBC's contribution to the Davis campaign and five additional political contributions made by CIBC executives. CIBC was forced to disgorge over \$379,000 it received in underwriting fees from California during the two year period following the contribution and pay a civil penalty of \$75,000. Two of the employees were each ordered to pay \$25,000 penalties.⁶

Summary

In today's information age, supervisory and compliance personnel must be in a position to actively monitor and enforce various regulatory requirements related to municipal political contributions. Dealers should continue to train their staff on the pertinent regulations. So, as we watch the 2008 presidential race to the White House, municipal securities firms are reminded to monitor their firm's political contribution activity with the same interest and conviction.

4- FINRA Case# E042005008101

5- NASD Case# E8A2004001301

6- SEC Administrative Proceeding File No. 3-12123

Rogue Trading: Old Topic...Renewed Focus

In response to several recent cases involving allegations of unauthorized or “rogue” trading resulting in substantial losses to firms in the United States and abroad, FINRA released Regulatory Notice 08-18 (“RN 08-18”) to remind member firms of the requirement to implement comprehensive reviews and risk management systems to monitor overall trading activity.

The risks associated with unauthorized proprietary trading are not new concepts and most firms that conduct proprietary trading and allow traders to commit the firms’ capital have implemented policies and procedures designed to prevent unauthorized trading. Although most firms have established such policies and procedures, the recent rise in unauthorized trading activity appears to indicate that firms have not properly implemented or enforced those procedures. These recent events highlight the importance of routinely reassessing the adequacy and effectiveness of those systems, particularly in light of the increasingly global nature of the financial services industry, the highly competitive trading environment, and the complexity of many of the products being traded.

RN 08-18 is also the result of FINRA’s recent solicitation of sound business practices and internal controls related to trading practices utilized by a number of small to mid-sized member firms. FINRA’s analysis concluded the presence of the following six sound practices/concepts present in the majority of firms analyzed:

- Mandatory Vacation Policies
- Heightened Scrutiny of Red Flags
- Protection of Systems and Risk Management Information
- Supervision and Accountability
- Intercompany Transactions; and
- Strong Compliance Culture.

Perhaps the most critical concept highlighted in FINRA’s notice, as well as the recently publicized cases, is that the lack of a strong culture of compliance in many organizations leads to supervisory failures. In order to establish and implement a rigorous internal controls system that effectively monitors trading activity, it is necessary to institute a strong culture of compliance stemming from the “tone” set at the top of each organization. Each firm’s compliance focus and intolerance for activity outside of the firm’s written supervisory procedures should be clearly communicated to all firm staff. Additionally, compliance and operational staff must obtain the proper training and be provided the proper authority within the organization to implement fully the firm’s monitoring activities. The results of such monitoring should be communicated periodically to members of senior management. Practically speaking, as trading practices and systems become more sophisticated, it is imperative that member firms continue to enhance their supervisory systems, internal controls and monitoring to keep pace with the evolving marketplace.

Regulation S-P...Changes are Looming

In response to growing concern for the protection of investors' private, personal information, on March 13, 2008, the SEC proposed revisions to Regulation S-P.¹ Regulation S-P currently requires financial institutions such as broker-dealers to report their privacy policies and procedures to customers and adopt procedural, electronic and physical safeguards to protect non public customer and consumer information.

With increasing technological advancements that both benefit and pose a risk to the securities industry, the SEC is concerned that firms may not be staying up-to-date and modifying their compliance programs to effectively protect against emerging fraudulent techniques and practices of identity thieves.

Perhaps the additional underlying reason of the SEC's proposal is the statistical rise in crimes related to sensitive customer information. The Federal Bureau of Investigation estimates that cyber crime is responsible for more than \$120 million in damages annually, which only represents 9 percent of cyber crime that is even reported. This puts the total cost of the problem at a staggering \$1.33 billion annually.² Banks, credit unions, broker-dealers and other financial institutions are the most likely locations for possible breaches of customer privacy. Studies also suggest that the entities most susceptible are those financial institutions supporting on-line banking, brokerage and conducting e-commerce. Security breaches such as identity theft and fraud have far-reaching impacts, ranging from remediation costs and damages payable to victims, cost of implementing new monitoring and intrusion prevention tools, to the inestimable toll of negative publicity and lost business.

Recent Privacy Cases

Online brokerage TD Ameritrade Holding Corporation remains in final settlement talks surrounding a class-action lawsuit over the theft of

customer contact information for more than 6 million of its customers. As part of a proposed settlement, Ameritrade agreed to pay nearly \$1.9 million in legal fees and cover the cost of one year of anti-spam email service for the victims.³ In an unrelated case, an SEC administrative law judge found that NEXT Financial Group violated Regulation S-P customer privacy provisions by asking recruits to submit nonpublic personal information about their customers without the customers' permission.⁴ The judge fined the firm \$125,000 and issued a cease and desist order. The aforementioned actions appear to indicate a regulatory shift and litigation focus on not only breaches of customer privacy protection, but also financial intermediaries' processes for ensuring protection of such information.

Proposal Focus Areas

The SEC's proposal focuses on four main areas of concern with regard to the privacy rule:

- **Adopt specific detailed safeguards against data security breaches.** This includes the requirement that each firm construct, execute and sustain an "information security plan." This plan will require written procedures for protection on the administrative, technical and overall physical side of the firm. The size of this plan should be commensurate with the firm's size and range of its business. The proposal also suggests that security plans should address recent identity theft events within the securities industry. (CONTINUED)

1- SEC Release Nos. 34-57427; IC-28178; IA-2712; File No. S7-06-08 (March 13, 2008)

2- www.infosecurityproductsguide.com

3- Funk, Josh. "TD Ameritrade close to settling data theft lawsuit." Associated Press June 18, 2008.

4- Office of Administrative Law Judges Initial Decision Release No. 349, June 18, 2008.

- **Increase the range of personal information that will be protected by the firm as well as designating employees personally responsible for the safeguard and disposal of investor's personal information.** This information includes any "non-public" personal information in paper, electronic or any other form, including personal information of employees of the firm. Firms would be required to appropriately safeguard and dispose all such information.
- **Require firms to keep written policies and procedures on how they intend to safeguard and dispose of sensitive client information.** These records would also include reports of incidents relating to the unauthorized use of personal information. The SEC believes that stronger policies and procedures will help firms monitor breaches in security for future protection. This will help with internal audits and streamline the review of records by regulators.
- **Establish the type of customer information that employees can retain when moving from**

one financial institution to another. The SEC accepts the fact that representatives of firms attempt to transition clients when they move to a new employer, as client relationships are often personal relationships. The new rule respects this reality and grants an exception from the notice and opt-out requirements for limited information sharing to allow contact information (but no other information) to move to the new firm.

The Impact

If the changes are adopted as proposed, most broker-dealers will have to make significant procedural and infrastructure changes to comply with the new regulations. Customer privacy will become a critical component of each firm's compliance program, perhaps requiring additional resources to be allocated to enhance required policies and procedures and to monitor their effectiveness.

In Case You Missed It!

On July 15, 2008, the Financial Crimes Enforcement Network ("FinCEN") released its Section 314(a) statistics.¹ Section 314(a) regulations enable federal law enforcement agencies, through FinCEN, to reach out to more than 45,000 points of contact at more than 27,000 financial institutions to locate accounts and transactions of persons that may be involved in terrorism or money laundering.

To date, FinCEN's 314(a) Program Office has processed 843 requests submitted by eighteen Federal agencies. Federal law enforcement organizations have submitted cases in the conduct of Terrorism/Terrorist Financing (276) and Money Laundering (567).

These requests included 7,654 subjects of interest. Of these, financial institutions have responded

with 50,907 total subject matches: 49,869 positive and 1,038 inconclusive. Based upon the fifty-two percent of 314(a) feedback that has been received from the law enforcement requesters, 51 percent of 314(a) requests have contributed to arrests or indictments. There have been 28 closed cases directly reported on all feedback forms. Of these indicated closed cases, there have been a total of 47 convictions.

1- http://www.fincen.gov/statutes_regs/patriot/pdf/314afactsheet.pdf

Regulatory Notices, Updates, and Rule Changes

June

FINRA Regulatory Notice 08-33 SEC Announces Approval of Amendment to FINRA's MRVP to Include Violations of Options Position and Exercise Limits and Contrary Exercise Advice Procedures; Effective Date: June 6, 2008.

FINRA Regulatory Notice 08-31 SEC Approves Exemption from the Requirements in NASD IM-2110-2 and NASD Rule 2111 for Certain Regulation NMS-Compliant Intermarket Sweep Orders; Effective Date: May 6, 2008.

MSRB Notice 2008-29 Further Technical Amendments Filed To Rules G-12 and G-8. MSRB Notice 2008-26 Requests for Comment on Publication of MSRB Rule Book.

MSRB Notice 2008-26 Requests for Comment on Publication of MSRB Rule Book.

May

FINRA Regulatory Notice 08-28 SEC Approves Amendments to Eliminate the Requirement for the Senior Registered and Compliance Registered Options Principals (SROP and CROP); Effective Date: June 23, 2008.

FINRA Regulatory Notice 08-27 The Obligation of Firms When Supervising their Registered Representatives' Use of Marketing Materials to Establish Expertise.

FinCEN Releases Tenth Issue of SAR Activity Review - By The Numbers (05/30/2008).

FinCEN Launches New Website New features enable institutions to view industry-specific news.

April

FINRA Regulatory Notice 08-20 FINRA Requests Comments on Proposed Changes to Forms U4 and U5.

FINRA Regulatory Notice 08-18 Sound Practices for Preventing and Detecting Unauthorized Proprietary Trading.

FINRA Regulatory Notice 08-16 Member Firm Disclosure and Supervisory Review Obligations; Effective Date: April 7, 2008.

SEC Release No. 34-57711 Disclosure of Divestment by Registered Investment Companies in Accordance With Sudan Accountability and Divestment Act of 2007 Effective Date: April 30, 2008.

SEC Release No.34-56501A Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks Effective Date: April 17, 2008

MSRB Notice 2008-21 Reminder Notice: MSRB 529 Compliance Seminars.

Conferences/ Roundtables/Webcasts

FINRA Conferences

Small Firm Conference

September 23, 2008 • Chicago, IL

Regulation and Compliance Conference

September 9, 2008 • New York, NY

Advertising Regulation Conference

October 2-3, 2008 • Washington, DC

Fall Securities Conference

October 22-24, 2008 • Carlsbad, CA

ACA Conferences

Live Conferences

ACA Fall 2008 Compliance Conference

September 8-10, 2008 • Boston, MA

ACA Chief Compliance Officer Roundtables

October 14-15, 2008 • Minneapolis, MN

December 2008 (TBD) • Dallas, TX

Webcasts

Fundamentals of Broker-Dealer Compliance

September 16, 2008

Nelson Rosa, Principal Consultant, ACA Compliance Group; Brian L. Rubin, Partner, Sutherland Asbil & Brennan, LLP

Broker-Dealer Rule Updates

November 18, 2008

Leigh Vazquez, Managing Director, ACA Compliance Group; Additional Speaker - TBD

Filing Dates

2008 Monthly/Quarterly FOCUS Part II/IIA Filings

Month Ending	Due Date
July 31, 2008	August 25, 2008
August 31, 2008	September 24, 2008
September 30, 2008	October 24, 2008

2007/2008 Annual Audit Filings

Fiscal Year End	Due Date
June 30, 2008	August 29, 2008
July 31, 2008	September 29, 2008
August 31, 2008	October 30, 2008

2008 Customer Complaint Filings

Quarter Ending	Due Date
3rd quarter 2008	October 15, 2008
4th quarter 2008	January 15, 2009

Did You Know?

Clearing Agreement

Whenever a clearing broker-dealer enters into a new clearing agreement with an introducing broker-dealer, the clearing broker-dealer must submit the agreement to FINRA for review and approval.

Nothing herein should be construed as legal advice or as a legal opinion for any particular situation. ACA makes no representations about the accuracy of the information contained herein or its appropriateness for any given situation.