REGULATORY UPDATE:
ISSUES RELEVANT TO FIXED-INCOME MARKET[1]

I. CREDIT RATING AGENCY UPDATE

UNITED STATES

Title IX of the Dodd-Frank Act both expands the SEC's oversight of credit rating agencies (CRAs) registered as national recognized securities rating organizations (NRSROs) and minimizes the role of ratings in the U.S. financial regulatory regime. Implementation of the requirements in the Dodd-Frank Act is in various stages of completion.

In May 2011, the SEC added to its rulemaking efforts for CRAs by proposing additional rules to govern CRAs' internal controls and procedures, conflicts of interest, rating methodologies, transparency, ratings performance, analyst training, rating symbology, and disclosures accompanying the publication of ratings. The SEC also proposed rules to eliminate references to credit ratings in certain of its regulations and issued a staff report in July 2011 reviewing the reliance on ratings. In July, the SEC also adopted some of the rules eliminating references to credit ratings in rules and forms under the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (1934 Act). Similarly, in December 2011, the Federal Reserve Board, the FDIC, and the OCC proposed rules to eliminate the use of credit ratings in the market risk capital rules.

The Dodd-Frank Act also imposes new self-executing governance requirements on NRSROs. The board of directors is charged with specific oversight of policies and procedures for determining ratings, conflicts of interest, and internal hiring and promotion. A minimum of half of the board must be composed of independent directors, with a portion of such directors to include users of ratings. Further, independent directors must serve for a fixed, non-renewable term not to exceed five years. Their compensation may not be linked to the business performance of the NRSRO.

The SEC has started to tackle some of the changes to CRA liability arising from the Dodd-Frank Act. For example, the exemption from the consent-filing requirement for registration statements (Section 11) that was provided to NRSRO's through Rule 436(g) of the 1933 Act has been eliminated. To address the resulting backlash from NRSROs unwilling to provide their consent to include their rating in a registration statement, the SEC issued a no-action letter to allow issuers of asset-backed securities to distribute registration statements without such ratings. The no-action position was extended indefinitely in November 2010. In addition to the Section 11 liability, the Dodd-Frank Act modified the "state of mind" requirement for private securities fraud actions against CRAs for money damages; created a duty to report violations of law; and modified the enforcement and penalty provisions of the 1934 Act to apply to CRA statements to the same extent as registered public accounting firms or securities analysts.

[1] Prepared by Heather Traeger and Tristan Morales of O'Melveny & Myers LLP.

As mandated by the Dodd-Frank Act, the SEC is in the process of establishing an Office of Credit Ratings—a process that has been hampered by SEC funding issues. Even so, the SEC was able to complete and publicize its annual examination of each NRSRO. The report was published on September 30, 2011. During its examination, the SEC found continuing failures at each of the NRSROs, including failures to follow proper ratings methodologies, failure to make necessary disclosures, and insufficient supervisory systems regarding conflicts of interest. The report identified a number of steps the SEC had taken as part of its enhanced oversight of credit rating agencies in order to address these shortcomings.

The SEC also is in the process of conducting two studies as required by the Dodd-Frank Act. First, the SEC sought comment on a study of the feasibility and desirability of standardizing certain components of ratings and ratings criteria, including credit-rating terminology, market stress conditions under which ratings are evaluated, and the necessity for a quantitative correspondence between CRAs and a range of default probabilities and loss expectations under standardized conditions of economic stress. Second, the SEC sought comment on a study regarding assigned credit ratings for structured finance products. Specifically, the study is designed to explore the feasibility of establishing a system in which a public or private utility or a self-regulatory organization would assign an NRSRO to determine credit ratings for structured finance products. The study also is required to examine alternative models for improving the quality of structured finance product ratings, including reviewing the current process for rating such securities. The comment periods related to both of these studies have closed.

CRAs currently registered with the SEC as NRSROs include:

- A.M. Best Company, Inc.
- DBRS Inc.
- Egan-Jones Rating Company
- Fitch, Inc.
- Japan Credit Rating Agency, Ltd.
- Kroll Bond Rating Agency
- Moody's Investors Service, Inc.
- Rating and Investment Information, Inc.
- Realpoint LLC
- Standard & Poor's Ratings Services

EUROPEAN UNION

The European Union (EU) has been actively engaged in reforming the regulatory regime for CRAs. Following upon a consultation and a roundtable, the European Commission proposed draft regulation in November 2011 that would heighten regulation of CRAs, forcing them to adhere to stricter rules, greater transparency requirements, and expanded legal liability. The EU has identified four goals of the new regulation.

First, the regulation is designed to ensure that financial institutions do not blindly rely on credit ratings when investing. Here, the Commission aims to limit references in regulation to external rating agencies and to instead require financial institutions to do their own due diligence. The new proposal would apply this regulatory shift to the rules relating to fund managers. Moreover, the regulation would require more disclosure from CRAs regarding the basis for their ratings. CRAs would be required to communicate their ratings to the European Securities and Markets Authority (ESMA) for listing on a European Rating Index (EURIX).

Second, the regulation is drafted to provide more transparent and more frequent sovereign debt ratings. The regulation requires EU Member States to be rated every six months instead of every twelve months. Ratings agencies would be required to include underlying facts and assumptions alongside ratings.

Third, the regulation should increase the diversity and independence of CRAs. The regulation would force financial institutions to rotate CRAs at least every three years. This limitation applies to corporate debt and structured financial instruments but not sovereign debt. These rules would allow CRAs to rate a maximum of ten debt instruments. A new contract between a CRA and a financial institution would be permitted only if a four-year cooling off period has followed previous ratings. Ratings from two separate agencies would be required for complex structured financial instruments. CRA shareholders are the subject of a number of provisions. Large shareholders of one CRA would be prohibited from holding substantial stakes in another CRA. A CRA would be barred from issuing ratings where an actual or potential conflict of interest exists for someone with a large holding or influence over the CRA, for instance, when that individual has an investment in the rated entity. Shareholders with significant influence over the CRA would also be prohibited from providing most consulting services to the rated entity.

Fourth, the regulation aims to make CRAs more accountable for their ratings. The regulation would make CRAs liable in national courts if they infringe, intentionally or with gross negligence, the CRA regulation, causing damage to an investor that relied on the rating. Interestingly, the burden of proof in such cases would rest on the CRA.

On January 24, 2012, the EU's Economic and Monetary Affairs Committee held public hearings on the CRA reform proposals. The Committee then issued a draft report dated February 15 that supports certain measures that originally were discussed as part of the regulation but were not included. For example, the report proposes to empower the EU to ban sovereign ratings if countries do not want them; to create an independent public European CRA; and to remove all references in EU laws to the need for ratings. At this time, no formal rules or directives have been codified.

In addition to the reform proposals discussed above, the EU has pursued other efforts to reduce the reliance of investors and market participants on ratings. In July of 2011, the European Commission proposed a new Capital Requirements Directive (CRD IV) that strives to reduce credit institutions' reliance on external credit ratings by:

- requiring that all banks' investment decisions are based not only on ratings but also on their own internal credit opinion; and

- that banks with a material number of exposures in a given portfolio develop internal ratings for that portfolio instead of relying on external ratings for the calculation of their capital requirements.

Finally, plans have been announced to launch a European CRA by Fall 2012 that would serve as a profit/non-profit foundation, competing in the credit ratings arena. Backers of the agency have said that the agency will differentiate itself by accepting legal liability for its analysis.

The list of rating agencies registered in the EU as of January 6, 2012 follows:

- Euler Hermes Rating GmbH
- Japan Credit Rating Agency Ltd
- Feri EuroRating Services AG
- Bulgarian Credit Rating Agency AD
- Creditreform Rating AG
- PSR Rating GmbH
- ICAP Group SA
- GBB-Rating Gesellschaft für Bonitätsbeurteilung GmbH
- ASSEKURATA Assekuranz Rating- Agentur GmbH
- Companhia Portuguesa de Rating, SA (CPR)
- AM Best Europe — Rating Services Ltd (AMBERS)
- DBRS Ratings Limited
- Fitch France S.A.S.
- Fitch Deutschland GmbH
- Fitch Italia SpA
- Fitch Polska SA
- Fitch Ratings España S.A.U.
- Fitch Ratings Limited
- Fitch Ratings CIS Limited
- Moody's Investors Service Cyprus Ltd
- Moody's France S.A.S.
- Moody's Deutschland GmbH
- Moody's Italia S.r.l.
- Moody's Investors Service España SA
- Moody's Investors Service Ltd

- Standard & Poor's Credit Market Services France S.A.S.
- Standard & Poor's Credit Market Services Italy S.r.l.
- Standard & Poor's Credit Market Services Europe Limited
- CRIF SpA

II. STRUCTURED FINANCE PRODUCTS/ASSET-BACKED SECURITIES

The Dodd-Frank Act has transformed the securitization market by significantly changing the regulatory requirements for issuers, underwriters, raters and distributors, among others, of such securities. Many of the more complex reforms, including credit-risk retention, conflicts of interest, and certain disclosure and reporting requirements for structured finance products, are works in progress. A number of the mandated changes, however, have been adopted.

Completed reforms include those related to asset reviews, rating agencies, and repurchase requests, representations and warranties. For example, ABS issuers must perform an asset review in connection with an offering and disclose their findings in the registration statement. The review may be conducted by an independent third party if: (1) the third party is named in the registration statement and consents to being deemed an "expert" for liability purposes under Section 11 of the 1933 Act or (2) the issuer adopts the finding and conclusions of the third-party reviewer. In addition, ABS issuers (or organizers) must disclose fulfilled and unfulfilled repurchase requests across all ABS transactions, at the time of offering and on an on-going basis. CRAs must explain representations, warranties, and enforcement mechanisms available to investors, as well as how they differ from similar issuances, in reports accompanying credit ratings.

The SEC also adopted rules related to the suspension of certain reporting obligations for asset-backed securities. The Dodd-Frank Act eliminated the automatic suspension of the duty to file annual and other reports under the Exchange Act but authorized the SEC to adopt rules suspending or terminating that duty. In keeping with that mandate, the SEC will provide a limited suspension: (1) immediately upon the filing of the requisite certification, if (a) there are no asset-backed securities of the class that were sold in a registered transaction still outstanding, and (b) the issuer has filed all required reports for the last three fiscal years; or (2) at the beginning of a semi-annual fiscal period (other than a period in the fiscal year in which the registration statement became effective or, for shelf offerings, the takedown occurred) if (a) there are no asset-back securities of that class that were sold in a registered transaction held by non-affiliates of the depositor and (b) the requisite certification has been filed.

The Federal Accounting Standard Board revised the accounting rules relating to sales of financial assets and consolidation of certain off-balance sheet entities. The FDIC increased the level of credit risk that financial institutions must retain to be eligible for its "securitization rule" safe harbor and amended its rules to reflect FASB's changes to the accounting rules. Likewise, the banking regulators amended their bank capital rules to reflect the FASB changes. The banking regulators also enacted the Hiring Incentives to Restore Employment Act, which imposes a 30% withholding tax on certain offshore securitization vehicles for failure to report payments to U.S. persons.

The most noteworthy proposals that are not finalized relate to credit risk retention and conflicts of interest under the Dodd-Frank Act and disclosure, reporting and registration under Regulation AB II. The SEC also has issued an advanced notice of proposed rulemaking soliciting comment on amendments to the conditional exclusion from the definition of "investment company" for asset-backed issuers. The comment periods have closed for all of these proposals. The highlights of these proposals are summarized below.

On March 29, the SEC and five federal banking and housing agencies released proposed rules generally requiring sponsors/securitizers of asset-backed securities to retain at least 5% of the credit risk relating to the assets that underlie such asset-backed securities. If an originator retains some amount of risk, the securitizer will be allocated the remaining amount of risk up to 5%. Risk retention can take the form a "vertical" slice, "horizontal" first-loss position, an "L-shaped interest" hybrid of vertical and horizontal retention, a funded cash reserve account, or ownership of a representative sample. The proposal includes a risk-retention option specifically designed for certain commercial mortgages and asset-backed commercial paper conduits and revolving master trusts.

To prevent sponsors from effectively reducing their economic exposure, a premium-capture reserve account must be established for excess spread. In addition, a securitizer may not hedge or transfer credit risk, unless such activity is not materially related to the credit risk of a particular asset-backed security interest or exposure required to be retained. A securitizer may, however, hedge general-interest-rate risk, currency-exchange-rate risk, and overall market-movement risk.

The proposed rules provide a complete exemption for securities collateralized exclusively by "qualified residential mortgages" that meet stringent underwriting standards, asset-backed securities guaranteed by the federal government, and certain single tranche resecuritizations. Special treatment is also provided for certain securities that are backed by qualifying commercial loans, commercial real estate loans, and automobile loans. In addition, there is a conditional safe harbor for certain foreign transactions. The proposal does not speak to tender-option bond programs and whether such programs are outside the scope of the proposal.

As proposed, regulations relating to credit-risk-retention requirements would become effective one year from adoption for residential mortgage assets, and two years from adoption for all other asset classes.

In September, the SEC proposed Rule 127B under the 1933 Act to prohibit certain conflicts of interest in connection with certain securitizations. The new rule would prohibit any securitization participant—underwriter, placement agent, initial purchaser, sponsor, or related subsidiaries or affiliates—from engaging in any transaction that involves or results in a material conflict of interest between such securitization participant and an investor in the relevant asset-backed security transaction. The rule only would apply if the asset-backed transaction involves (i) covered persons; (ii) covered products; (iii) a covered timeframe; (iv) a covered conflict; and (v) a "material conflict of interest." The rule includes exceptions for certain risk-mitigating hedging activities, purchases and sales to provide liquidity, and bona fide market making.

The primary components of Regulation AB II that remain outstanding include revisions to reporting, disclosure, and registration requirements for asset-backed securities. First, the SEC has proposed certain criteria for shelf-registration eligibility. An asset-backed issuer must satisfy all three of these criteria:

- The chief executive officer of the depositor, or an executive officer in charge of securitization, must certify at the time of each offering of a shelf registration statement that the securitization is designed to produce cash flows at times and in amounts sufficient to service expected payments on the asset-backed securities being offered and sold and that the disclosures contained in the prospectus are accurate.

- The underlying transaction agreements must include provisions adopting dispute-resolution procedures regarding repurchase requests, and requiring the trustee of the issuing entity to appoint a third-party credit risk manager to perform a review of assets upon certain triggering events, and to provide a report of the findings and conclusions of its review to the trustee.

- The underlying transaction agreements must contain provisions concerning investor communication. In accordance with such provisions, the party responsible for making periodic filings on Form 10-D must include notice of any requests from an investor to communicate with other investors related to an investor's rights under the terms of the asset-backed security.

Under the re-proposed rules, issuers of asset-backed securities would be required to perform annual compliance checks.

Second, the SEC has re-proposed certain disclosures. It seeks comment on the provision of specific asset-level data, including data with unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or securitizer of such assets. The proposed revisions also would require an asset-backed issuer to file copies of the underlying transaction documents, in substantially final form, at the same time as a preliminary prospectus is filed. In addition, the preliminary prospectus would need to be filed at least five business days prior to the first sale or, if used earlier, within two business days of first use. It would need to be a single prospectus and include all information omitted from the form of prospectus in the registration statement other than pricing information. Further, the re-proposal would require an issuer to provide an investor, upon request, with substantially the same information that the issuer would have to provide for a public offering or any of the issuer's asset-backed securities and structured product offerings conducted pursuant to Rule 144A or Regulation D under the 1933 Act.

As part of the review of credit ratings in SEC rules, the SEC is considering modifications to the conditional exclusion from the definition of "investment company" for asset-backed issuers found in Rule 3a-7 of Investment Company Act of 1940. Specifically, the SEC is evaluating whether the conditions, which refer to ratings by NRSROs, should be replaced with alternate standards of creditworthiness. The SEC is seeking comment on a broad range of issues designed to address investor protection. For example, the SEC is seeking comment on whether it should impose specific requirements or limitations on the structure and operations of asset-backed

issuers relying on the exclusion to prevent abusive practices such as self-dealer and overreaching by insiders, misevaluation of assets, and inadequate asset coverage. The SEC also questions whether it should requires an asset-backed issuer to obtain an opinion from an independent evaluator prior to the sale of its fixed-income securities stating that the evaluator reasonably believes that the issuer is structured and would operate in a manner that would allow the issuer to satisfy expected payments on the securities.

In addition, the SEC is reviewing whether provisions of other federal securities rules applicable to asset-backed securities should be incorporated into Rule 3a-7, such as the proposed risk retention requirements discussed above. The SEC also is considering whether use of the exclusion should be limited to, for example, those issuers who meet the shelf eligibility requirements or Regulation AB requirements discussed above. Holders of securities issued by asset-backed issuers relying on Rule 3a-7 are under review too. The SEC is exploring whether such investments should be considered "investment securities" for purposes of determining whether the holders are investment companies. Finally, the SEC is seeking comment as to why certain asset-backed issuers rely on the exclusion from definition of investment company for certain factoring, discounting and mortgage companies instead of the Rule 3a-7 exclusion.

Legislators do not appear to be finished with the Dodd-Frank Act or asset-backed securities. On February 16, 2012, the House Financial Services Committee reported out HR 1838, which modifies the swaps pushout rule in the Dodd-Frank Act. The only swaps that would have to be pushed out of a bank are "structured finance swaps" that are not undertaken for hedging or risk-management purposes and are based on an asset-backed security (or group or index primarily comprised of asset-backed securities) that do not meet regulatory credit quality standards and that are not jointly permitted in rules adopted by the banking regulators. The bill defines a "structured finance swap" as a swap or security-based swap based on an asset-backed security (or a group or index primarily comprised of asset-backed securities).

III. REGULATORY REMINDER - MUNICIPAL SECURITIES

FINRA

- **REGULATORY NOTICE 10-41 - MUNICIPAL SECURITIES - September 2010**

  In September 2010, FINRA issued a regulatory notice reminding firms of their sales practice and due diligence obligations when selling municipal securities in the secondary market. In order to satisfy disclosure, suitability, and pricing obligations under rules of the Municipal Securities Rulemaking Board (MSRB) and federal securities laws, brokers, dealers, and municipal securities dealers are required to fully understand the municipal securities they sell. Dealers must obtain, analyze, and disclose all material facts about secondary-market transactions that are either known to or reasonably accessible to the dealer through established market sources. These sources include, but are not limited to, continuing disclosures, trade data, and other information made available through the MSRB's Electronic Municipal Market Access system (EMMA). An obligation may exist to obtain and disclose information not available through EMMA if it is material and available through other public sources. A firm is not relieved of its duty to disclose material information simply because that information is publicly available.

Firms are required to use this information to determine the prevailing market price of a security and to establish a fair sale price for the customer. Firms may not simply rely on a security's credit rating but must perform an independent analysis of the securities they sell.

MSRB

- **MSRB NOTICE 2011-67 - November 30, 2011**

  The November 2011 notice provided answers to frequently asked questions pertaining to dealer disclosure obligations under Rule G-17. The Rule generally provides that, in municipal securities activities, dealers must deal fairly with all persons and must not engage in deceptive, dishonest, or unfair practices.

- **MSRB NOTICE 2011-66 - November 28, 2011**

  This November 2011 notice addressed Rule G-23 which establishes ethical standards and disclosure requirements for persons acting as financial advisors to issuers of municipal securities. The notice clarified that the revised Rule G-23 served solely as a conflicts-of-interest rule and does not address whether providing advice under the rule would cause a dealer to become a "municipal advisor" subject to a fiduciary duty under the Securities Exchange Act of 1934.

- **MSRB NOTICE 2011-50 - September 8, 2011**

  In September 2011, the MSRB issued a proposed draft rule governing the obligations of broker's brokers and a draft interpretive notice on the obligation of dealers that use the services of broker's brokers. The proposed Rule G-43 would require a broker's broker to make a reasonable effort to obtain a price for a dealer that was fair and reasonable in relation to prevailing market conditions. Among other provisions, the rule includes a safe harbor for a broker's broker that conducts bid-wanteds and offers in a prescribed manner.

  Under the draft notice, selling dealers would be reminded of their independent duty under Rule G-30 to determine that the prices at which they purchase municipal securities from their customers is fair and reasonable. Bidding dealers that submitted bids to broker's brokers that they believed were below market value would violate Rule G-13.

IV. 2011 FIXED-INCOME ENFORCEMENT CASES

FINRA

- **CHASE INVESTMENT SERVICES - January 2012**

  FINRA ordered Chase Investment Services Corporation (Chase) to reimburse customers over $1.9 million for losses incurred based on recommended purchases of unit investments trusts (UITs) and floating-rate loan funds. FINRA also fined Chase $1.7 million.

FINRA concluded that Chase brokers improperly recommended the purchase of UITs to unsophisticated customers on at least 260 occasions. These UITs generally held a large percentage of high-yield or junk bonds. Investing in these instruments caused customer losses of roughly $1.4 million. The floating-rate funds were also subject to significant credit risks, and recommendations to purchase these funds caused customers to lose nearly $500,000.

FINRA also found that Chase failed to implement reasonable supervisory procedures for UITs and floating-rate loan funds. As a result, Chase brokers sold these instruments without the guidance necessary to determine whether they were suitable for customers.

- **MORGAN STANLEY - December 2011**

  FINRA fined Morgan Stanley & Co. Inc. and Morgan Stanley Smith Barney LLC $1 million and ordered $371,000 in restitution after identifying excessive markups and markdowns to customers on corporate and municipal bond transactions.

  FINRA found the markups and markdowns, which ranged from 5 percent to 13.8 percent on bond transactions, excessive given factors such as market conditions, cost of executing the transactions, and value of services rendered.

  Morgan Stanley's related supervisory systems were also deemed inadequate. These systems did not identify markups and markdowns below 5 percent that may nonetheless have been excessive. For a period, these systems only detected one of the two charges that the firm added to the price of a bond when determining whether a mark was fair and reasonable.

- **NORTHERN TRUST SECURITIES - August 2011**

  FINRA fined Northern Trust Securities $600,000 for deficiencies in supervising sales of high-volume securities trades and collaterized mortgage obligations (CMOs). With respect to fixed income, FINRA noted that Northern Trust had no systems in place to monitor trades of over 250 bonds. As a result, the organization failed to review these trades for suitability, concentration, excessive trading, excessive mark-ups, or commissions, or for trading in restricted stocks.

- **MORGAN KEEGAN - August 2011**

  Alongside the SEC and five state regulators, FINRA announced a settlement of enforcement proceedings against Morgan Keegan & Company, Inc. that will require the company to pay $200 million in restitution to customers who invested in seven affiliated bond funds.

  Morgan Keegan sold an Intermediate Fund that invested primarily in structured products, including mezzanine and subordinated tranches of structured securities, including subprime products. The Fund was marketed as a safe, fixed income mutual fund investment, when in reality it was exposed to risks associated with asset-backed securities and subordinated tranches of structured products. The company initially sold a fund to

investors using sales materials containing claims that were not fair and balanced and did not provide a sound basis for evaluating the investment.

When the Fund began experiencing difficulties related to investment in asset-backed securities, the company failed to disclose those risks in sales materials or internal guidance. Over 50 percent of the Fund was eventually invested in asset-backed securities, and 13.5 percent was invested in subprime products. Morgan Keegan failed to take steps reasonably designed to revise advertising materials and otherwise inform customers of the risks of the fund under current market conditions.

- **UBS - June 2011**

  FINRA fined UBS Financial Services Inc. $2.5 million, and required UBS to pay $8.25 million in restitution for statements and omissions that misled investors regarding the "principal protection" feature of 100 percent Principal-Protection Notes (PPNs) that Lehman Brothers Holdings Inc. issued prior to its 2008 bankruptcy.

  PPNs are fixed-income security structured products with a bond and option component that promise a minimum return equal to an investor's initial investment. As the 2008 credit crisis worsened, UBS advertised the notes as principal-protected investments without emphasizing that the notes were unsecured obligations of Lehman Brothers. FINRA found that UBS failed to emphasize that the PPNs were subject to issuer credit risk, failed to analyze the suitability of PPN sales to certain customers, failed to properly advise UBS financial advisors of Lehman's escalating default risks, and failed to establish proper supervisory measures for PPNs.

  FINRA found that even some UBS financial advisors did not understand the complex products they were selling, and the associated issuer credit risks. As a result, customers were either misled or underinformed on investment risks.

- **SOUTHWEST SECURITIES - May 2011**

  FINRA fined Southwest Securities Inc. $500,000 for using paid consultants to solicit municipal securities business and for violations of other MSRB rules.

  FINRA found that over nearly a three-year period, Southwest paid five individuals, including three former Texas municipal issuer officials, to obtain a total of 24 municipal securities underwritings . The consultants were paid more than $200,000 and promised a percentage of profits from any municipal securities business they helped solicit.

  Southwest's systems for supervising its municipal securities business was also deemed inadequate. The firm's procedures had not been adjusted to reflect a 2005 amendment to MSRB Rule G-38 that prohibited payments to unaffiliated individuals for solicitation of municipal securities business. Additionally, the firm failed to enforce its procedures requiring municipal finance professionals to pre-clear political contributions. Based on these systems failures to detect such a political contribution, the SEC brought a 2010 regulatory action against Southwest.

Finally, FINRA found that Southwest violated MSRB rules by failing to file 10 MSRB forms G-36(OS) and G-36(ARD) in a timely manner and for inaccurately reporting more than 300 municipal services transactions to the MSRB.

As part of its settlement, Southwest was required to review its compliance systems and to certify that they are reasonably designed to achieve compliance with MSRB rules.

- **APS FINANCIAL - February 2011**

  FINRA expelled APS Financial Corporation and barred the firm's former president and a former broker following a scheme which overcharged an elderly investor by $1.2 million. The transactions involved corporate high yield bonds, collateralized mortgage obligations, and collateralized debt obligations.

  FINRA found that the broker charged mark-ups ranging from 4.15 percent to 67 percent when executing 45 customer transactions. Forty-three of these were related to a single elderly investor, who was overcharged more than $1.2 million through undisclosed mark-ups.

  The President of APS approved 42 of the 43 excessive or fraudulent mark-ups for the elderly investor's accounts. FINRA found that the President failed to take reasonable steps to adequately supervise the firm's representatives.

<u>SEC</u>

- **CREDIT SUISSE GROUP - February 1, 2012**
  2012-23

  The SEC charged four former investment bankers and traders at Credit Suisse with participating in a scheme to fraudulently overstate the value of $3 billion in subprime bonds during the subprime credit crisis.

  According to the SEC, Credit Suisse's former global head of structured credit trading, former head of hedge trading, and two former mortgage bond traders deliberately ignored specific market information showing sharp declines in the price of subprime bonds under the control of their groups. The two department heads directed traders to change bond prices to hit daily and monthly profit targets, cover up losses in other trading books, and communicate profitability to senior management. Relevant accounting principles and Credit Suisse policy required that the price of the bonds be recorded to accurately reflect their fair value. The SEC has alleged that during the collapse of the subprime market, proper pricing would have reflected that Credit Suisse was incurring significant losses.

- **IN THE MATTER OF LISA B. PREMO - January 17, 2012**
  Administrative Proceeding - File No. 3-14697

  The SEC instituted administrative and cease-and-desist proceedings against Evergreen Investment Management Company and the lead portfolio manager of its Fund, Lisa B. Premo. According to the agency, Premo, who served as a member of the Evergreen

Valuation Committee (EVC) in addition to her lead portfolio manager role, became aware in 2008 that a collateralized debt obligation owned by the Fund had experienced a default event. Premo did not convey this information to the EVC, which was tasked with calculating the value of the Fund holdings. When the EVC subsequently became aware of the default event, it dropped the value assigned to the CDO from $6.98 million to $0.

In addition, the SEC alleges that Premo chose to override a valuation of the Fund's position provided by S&P on the basis that it was too low. The EVC subsequently relied solely on quotes provided by a Florida broker-dealer that did not value securities on a daily basis for any other Fund during the relevant period.

The SEC alleges that Premo willfully violated Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 and caused the Firm to violate those provisions by causing materially misleading information to be distributed. The agency also alleges that Premo willfully aided and abetted and caused the Fund's violation of Rule 22c-1(a) promulgated pursuant to Section 22(c) of the Investment Company Act, which requires registered investment companies to sell and redeem shares based on a proper NAV.

- **UBS GLOBAL ASSET MANAGEMENT - January 17, 2012**
  2012-8

The SEC obtained a settlement from UBS Global Asset Management (UBSGAM) following an SEC order instituting administrative proceedings against UBSGAM for failing to properly price securities in three mutual funds, resulting in a misstatement to investors of the net asset values (NAVs) of those funds. Without admitting or denying the SEC's findings, UBSGAM agreed to be censured, to cease and desist its violations of the Investment Company Act, and to pay a $300,000 penalty.

According to the SEC, in June 2008, UBSGAM purchased on behalf of mutual funds 54 complex fixed-income securities at a price of $22 million. Most of the securities were subordinated tranches of mortgage-backed securities. Subsequently, however, UBSGAM valued all but six of the securities at prices substantially in excess of transaction prices, including many at least 100 percent higher. The SEC alleges that the broker-dealer and pricing services that provided these valuations used stale quotes that were not priced daily. In using these third-party valuations, UBSGAM failed to implement its own written procedures, which generally required use of the transaction price until fair value was determined. By failing to implement its written procedures, UBSGAM is alleged to have violated Rule 38a-1 under the Investment Company Act.

By using improperly priced securities, UBSGAM also caused the NAVs of its mutual funds to be overstated by up to 10 cents per share for several days. According to the SEC order, this violated Rule 22c-1 of Section 22(c) of the Investment Company Act.

- **GE FUNDING CAPITAL MARKET SERVICES - December 23, 2011**
  2011-276

  Following SEC charges that GE Funding Capital Market Services engaged in pervasive corrupt practices in the municipal securities reinvestment market, the SEC reached a settlement requiring GE Funding CMS to pay approximately $25 million to affected municipalities or borrowers. The firm also reached agreements with the Department of Justice, Internal Revenue Service, and 25 state attorneys general that require payments of $45.35 million.

  According to the SEC, GE Funding CMS made improper, undisclosed payments to bidding agents in the form of inflated swap fees in exchange for the assistance of bidding agents in controlling the competitive bidding process. The firm allegedly won hundreds of municipal bond bids through a process of "last looks" that enabled it to secretly change its bids right before the bidding process closed. Other times, the firm participated in "set-ups" in which the bidding agent deliberately obtained non-winning bids from other providers in order to rig the bids in one participant's favor.

  The settlement concluded a 12-month period in which the SEC and other governmental entities obtained substantial settlements from other financial entities in connection with similar allegations of corruption in the municipal reinvestment market. Other financial institutions that concluded settlements with the SEC and other federal and state authorities include: Wachovia Bank N.A. - $148 million settlement on December 8, 2011; J.P Morgan Securities LLC - $228 million settlement on July 7, 2011; UBS Financial Services Inc. - $160 million settlement on May 4, 2011; and Banc of America Securities LLC - $137 million.

- **CITIGROUP GLOBAL MARKETS - October 19, 2011**
  2011-214

  The SEC charged SEC's principal American broker-dealer subsidiary with misleading investors about a $1 billion collateralized debt obligation (CDO) tied to the U.S. housing market. According to the SEC, Citigroup bet against its investments as the housing market worsened. When the CDO defaulted months later, investors were left with the losses while Citigroup made $160 million in fees and trading profits.

  Citigroup Global Markets structured and marketed a CDO, and exercised significant influence over selection of $500 million of its assets. Citigroup then took a proprietary short position against those assets. It failed to disclose to investors either its role in the asset selection process or its short position. One experienced Citigroup trader characterized the CDO portfolio in an email as "dogsh!t" and "possibly the best short EVER!"

  In order to settle the charges, Citigroup has agreed to pay $160 million in disgorgement plus $30 million in prejudgment interest and a $95 million penalty.

In related charges, the SEC also charged Credit Suisse's asset-management unit with violating its fiduciary duties to investors when it allowed Citigroup to significantly influence the portfolio selection process. Credit Suisse agreed to a set of cease-and-desist orders and a settlement amount of $2.5 million.

- **RBC CAPITAL MARKETS - September 27, 2011**
  2011-191

  RBC Capital consented to the entry of an SEC order charging the firm with improperly marketing and selling to Wisconsin school district trusts $200 million of credit-linked notes that were tied to the performance of synthetic collateralized debt obligations (CDOs). RBC Capital agreed to settle the charges by paying $30.4 million that will be distributed to the school districts.

  According to the SEC, the firm sold complex derivatives that were unsuitable for the school districts without fully informing them of the risks. Compared to the typical buyers of CDO-linked instruments, the districts were not sophisticated investors. Within RBC Capital itself, there were concerns about the suitability of the instruments for the districts. Accordingly, the SEC order found that the districts lacked the knowledge and sophistication to engage in such investments.

- **MORGAN KEEGAN - June 22, 2011**
  2011-132

  Morgan Keegan & Company and Morgan Asset Management agreed to pay $200 million to settle fraud charges related to subprime mortgage-backed securities. According to the SEC's order, the firm failed to employ reasonable pricing procedures and consequently did not calculate accurate "net asset values" (NAVs) for the funds. Nevertheless, the firm published the inaccurate daily NAVs and sold shares based on the inflated prices.

  According to the SEC, Morgan Keegan's former portfolio manager instructed the firm's fund accounting department to make arbitrary price adjustments to the values of portfolio securities. In order to maintain the inflated value of its securities, the portfolio manager both ignored lower-priced quotes by outside broker-dealers and screened price confirmations from broker-dealers to avoid quotes that required marking down the securities. As a result, Morgan Keegan prevented a reduction in the NAVs of the funds and failed to employ the requisite fair-valuation policies and procedures.

- **J.P. MORGAN - June 21, 2011**
  2011-131

  J.P. Morgan agreed to pay $153.5 million to settle SEC charges that it misled investors in a complex mortgage securities transaction at the outset of the housing crisis. According to the SEC, J.P. Morgan structured and marketed a synthetic collateralized debate obligation without informing investors that a hedge fund helped select the assets and had a short position in over half of those assets. The SEC has alleged that J.P. Morgan sold

roughly $150 million of mezzanine notes of the CDO's liabilities to investors who lost nearly their entire investment.

Although the firm's marketing materials stated that an investment advisory firm with experience analyzing CDO risk had selected the portfolio, a significant role in the selection process was allegedly played by a hedge fund with a substantial short position in the assets. The SEC brought separate charges against the head of the investment advisory firm for misrepresenting the role of his firm and the hedge fund in the asset selection process. This official was allegedly seeking employment at the hedge fund during the relevant time period.

- **TD AMERITRADE - February 3, 2011**
  2011-36

  TD Ameritrade agreed to an SEC order censuring the firm in the wake of charges that the firm failed to reasonably supervise its registered representatives, including some who misled customers when selling shares of a mutual fund that "broke the bank" in 2008. According to the SEC, firm representatives improperly characterized the fund as a money market fund, as safe as cash, or as an investment with guaranteed liquidity. They also failed to disclose actual investment risks. TD Ameritrade failed to establish the supervisory policies and procedures necessary to manage these transactions.

  As part of the settlement, the firm agreed to a censure order that, among other penalties, requires it to distribute approximately $10 million to customers who still hold shares of the fund.

- **KIMBALL L. YOUNG AND THOMAS S. ALBRIGHT - January 7, 2011**
  2011-5

  The SEC obtained a settlement from two former portfolio managers in the wake of charges that the managers defrauded a mutual fund that invests primarily in municipal bonds issued by the State of Utah and its county and local authorities. The former managers agreed to sanctions barring them from the industry in addition to disgorgement requirements and other financial penalties.

  According to the SEC, the two individuals improperly charged municipal bond issuers more than a half-million dollars in undisclosed "credit monitoring fees." These fees were charged, without the knowledge of the two managers' employer, on certain private placement and non-rated bond offerings. The fees ranged from 0.5 to 1 percent of each bond's par value. Although the managers claimed that the fees were necessary to compensate for their additional work in monitoring unrated bonds, the SEC found that any such monitoring was already part of their regular job responsibilities.

  Between the two former managers, the SEC order found a range of violations of the Investment Advisers Act of 1940 and the Investment Company Act of 1940. Both individuals were found to have violated Section 17(3) of the Investment Company Act of 1940, which prohibits any affiliated person of a registered investment company from

receiving compensation from any source other than the investment company in connection with the sale of such company's property.