

BANK RESTRICTED FROM HEDGE FUND SALES TO CLIENTS

As part of a settlement approved by the Securities and Exchange Commission (SEC) on August 5, 2014, America's third largest bank has agreed to cease selling hedge fund investments to its clients—at least for now. The case stems from bank practices in 2007 related to securities sales and comes almost one year after implementation of the SEC's "Bad Actor" rule. Private investment sales to large institutions are not affected by the agreement.

Part of Fraud Settlement

The cessation of hedge fund sales is part of a \$285 million fraud settlement with the SEC over allegations that sales of collateralized debt obligations in 2006 and 2007 led to more than \$700 million in losses for investors. The settlement prohibits the bank from selling investments in hedge funds and private-equity funds to its wealthy clients, and in accordance with the agreement, the bank has sent letters to hedge fund firms informing them that it can no longer offer their funds and private equity funds to clients. Until now, the bank has been offering about 40 hedge funds to clients via its private bank which manages \$310 billion. The private bank clients are required to have a net worth of at least \$25 million.

In 2011, a U.S. District Court in Manhattan originally denied approval of the settlement amount referring to it as "pocket change" for an institution the size of the defendant bank; however, upon reversal of that ruling by the Second U.S. Circuit Court of Appeals, the District Court judge approved the settlement. Other banks that had entered into similar settlements were not subject to such restrictions because their accords were reached before a change in the law became effective last year.

The "Bad Actor" Rule

Pursuant to Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) the SEC adopted the "Bad Actor" rule, which it codified under new SEC Rule 506(d) and (e). The rule bars companies or individuals with a "criminal conviction, regulatory or court order or other disqualifying event" that occurred after September 2013 from participating in private offerings. The rule became effective on September 23, 2013.

Efforts to Obtain a Waiver

Despite the settlement agreement, the bank is nevertheless attempting to resolve the hedge fund restrictions by way of a waiver request. The SEC grants waivers so that restricted firms can continue to conduct their pre-restriction business if the waiver is viewed as being in the public's best interest. A typical request argues that the activities for which approval is being sought are not directly related to the activities that prompted the settlement. Recently, some SEC officials have questioned the granting of waivers to repeat offenders.

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