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November 7, 2011

FINRA alters proposed communications rule but not training materials provision

FINRA has rebuffed industry efforts to change the proposed new communications rule so that it won't treat internal training materials in the same way it treats institutional communications. This means that, if finalized, the training materials you use to educate your reps on your firm's products and services would be subject to the same recordkeeping requirements that cover institutional communications.

Industry groups had opposed this provision on the grounds that it would impose new compliance and supervisory requirements on internal communications that don't exist under current

(Communications rule, continued on page 2)

Enforcement Alert

Action highlights compliance woes of some small firms, pros say

A recent **FINRA** enforcement action leveled against a New Jersey firm shows the supervisory challenges that some small broker-dealers can face when the CEO is the CCO, some pros say. Another pro argues that the firm's problems didn't necessarily stem from the CEO/CCO model but, rather, significantly flawed compliance work.

Not only was the firm hit with a $75,000 fine last week for a wide variety of violations that include major supervisory shortfalls, it has been suspended since February because of its failure to pay arbitration fees.

The firm, **Alternative Wealth Strategies, Inc**., mainly sold securities offered through Reg D private placements and had 32 registered persons operating from 23 branch offices, according to the Oct. 31 Letter of AWC.

(Alternative Wealth, continued on page 4)

Fraud-detection method could help firms conduct due diligence

New methods to help firms conduct due diligence on companies could be gathering steam, thanks to a collaborative effort by regulators, law enforcement, academics, and financial service practitioners to prevent and detect fraud.

Among the strategies talked about last week at a meeting of the **Research Center on the Prevention of Financial Fraud** was one designed to spot possible red flags through the examination of financial and non-financial information in 10-Ks.

If non-financial measures that are described in a 10-K such as retail outlets are going down, but the 10-K shows revenue going up – and that divergence is greater than what's happening at the company's competitors — it could be a sign that the 10-K is suspect, the strategy goes.

That's a simplified explanation of research headed up by a **North Carolina State University**

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Communications rule *(cont. from pg. 1)*

FINRA rules, the SRO said in an Oct. 31 letter to the **SEC** explaining its response to different comments.

FINRA said it disagrees with the groups' assertion.

"The current definition of 'institutional sales material' under NASD Rule 2211 includes any communication that is distributed or made available only to any NASD member or registered associated person of such a member," the SRO said. FINRA has settled a number of enforcement actions against firms involving misleading internal training materials that alleged violations of NASD Rules 2210 and 2211, it added.

Changes in proposal

But FINRA has made a few changes in its proposal. Among the changes, FINRA:

✔ Clarifies that a firm would have to have a principal approve a retail communication that's excepted from the definition of "research report" if the communication makes any financial or investment recommendation.

✔ Eliminates the filing requirement in the proposal for communications concerning government securities.

✔ Clarifies that a comparative illustration of the math principles of tax-deferred versus taxable compounding must disclose that ordinary income tax rates will apply to withdrawals from a tax-deferred investment.

✔ Modifies the proposal's disclosure requirements for retail communications and public appearances that include a recommendation of securities. A retail communication that contained a recommendation would have to disclose if the firm or any associated person "that is directly and materially involved in the preparation" of the communication has a financial interest in any of the securities of the issuer — unless it's just a nominal interest. If there was more than a nominal interest, the communication would have to describe the nature of the interest.

As for public appearances, a similar provision would apply to associated persons, but this particular provision wouldn't apply to public appearances of a research analyst that includes the applicable disclosures. This provision also wouldn't apply to a recommendation of investment company securities or variable insurance products, as long as the associated person has a reasonable basis for the recommendation.

✔ States that certain content standards in the rule wouldn't apply to prospectuses, preliminary prospectuses, fund profiles and similar documents that have been filed with the SEC. FINRA says it will clarify that those standards *would* apply to an investment company prospectus published according to Securities Act Rule 482 and a free writing prospectus that was filed with the SEC under Securities Act Rule 433(d)(1)(ii). ■

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OCIE is looking for 'discrepancies' at firms, Schapiro says

The **SEC's** Office of Compliance Inspections and Examinations contains a unit that is identifying firms by risk and targeting those that show unusual patterns of activity, such as claiming returns that are consistently high even when markets are down or mixed, SEC Chairman **Mary Schapiro** said last week.

Examples of other "discrepancies" that she said can be "red flags" in OCIE's eyes include:

- ✔ overstatement of assets;
- ✔ non-disclosure of affiliates; and
- ✔ misrepresenting custodial arrangements.

"Even something as simple as a tip that an individual is lying about their college degree, or that a broker claiming a PhD in finance cannot answer basic technical questions, can trigger additional scrutiny— particularly if a registrant emphasizes those credentials in promotional material," Schapiro said in a speech at the Stanford Center on Longevity — FINRA Investor Education Foundation Conference in Washington.

She also said OCIE is developing specialized working groups in six areas: Equity Market Structure and Trading Practices, Fixed Income and Municipals, Marketing and Sales Practices, Microcap Fraud, New and Structured Products, and Valuation.

In addition, the SEC currently has a study underway that is testing investors to determine the effectiveness of current SEC-mandated disclosure documents, she said. The results of the study — which was mandated by Dodd-Frank — will be used to find out ways to improve disclosure materials that SEC registrants are required to provide, Schapiro said. ■

Fraud detection *(cont. from pg. 1)*

professor, but it illustrates how the Center is trying to combine research with real-world practicality and identify highly effective ways to spot fraud and shield potential victims from it.

"What we're trying to do here is explore the state and future of financial fraud, to better understand it, and to see it from multiple perspectives so we're not shooting in the dark with strategies for prevention, but we're looking to people who are on the streets, who are on the front lines of fighting fraud, and who have the ability to tap into academic resources and bridge that gap," said **Gerri Walsh**, president of the **FINRA Investor Education Foundation**, and Vice President of FINRA Investor Education.

The 10-K strategy was devised by North Carolina State University professor **Joseph Brazel**, along with professors **Keith Jones** of **George Mason University** and **Mark Zimbelman** at **Brigham Young University**, who co-authored a paper on the topic in 2009 for the *Journal of Accounting Research*.

"Using a matched-pair sample of fraud firms and non-fraud competitors, we document that fraud firms are more likely than non-fraud firms to report inconsistent revenue growth relative to their growth in NFMs [non-financial measures]," the researchers write.

They note that non-financial measures mentioned in a 10-K such as the number of employees tend to be more easily verifiable than financial measures. And misrepresenting non-financial measures is tougher to cover-up than is the case with financial measures, they write. Hence, the strategy to look at the divergence — compared with competitors.

"The financial services community collectively can think about how to take this research and apply it to the work that they do, whether it's making recommendations about companies or simply being aware of what types of individuals might be more susceptible to investor fraud," Walsh said.

Fraud victims

Walsh says that other research has shed light on things such as the profiles of victims and fraudsters, and the efficacy of FINRA's investor education program. For instance, the type of financial fraud that's perpetrated tends to be geared toward a certain victim profile. The classic lottery scheme, where someone says "send me money so you can claim your lottery prize," tends to target widows in their 60s or 70s who have lower financial literacy levels, are lower-income, and have less education, Walsh said.

On the other hand, investment fraud tends to target college-educated men who score high on financial literacy tests, have a partner or spouse, have

(Fraud detection, continued on page 4)

Fraud detection *(cont. from pg. 3)*

a higher-income, and who tend to be more confident with risk-taking, she explained.

Walsh also said FINRA's investor education programs that combine education with free lunches have been shown to be effective. Research showed that attendees were 50% less likely to fall for a pitch for a fraudulent investment in an oil and gas scheme than investors who hadn't attended the educational session, she said.■

Alternative Wealth *(cont. from pg. 1)*

The issue and violations "went right to the fundamental core of broker-dealer supervision itself," said **Michael Clements**, the co-owner and CCO of **Riverside Financial**, a start-up investment adviser firm and the owner of **Wall Street Consulting Services, LLC**. Among rules violated were NASD rules 3010 and 3012 and FINRA rule 3130.

"It is an illustration of what can happen to many small firms if they don't have good compliance counsel within or without the firm," said **Paul Uhlenhop**, a partner in the Chicago law firm **Lawrence, Kamin, Saunders & Uhlenhop**

Among FINRA's findings, Alternative Wealth Strategies:

✔ Omitted material facts in connection with its sales of promissory notes. Specifically, from November 2008 through August 2009, the firm failed to disclose to investors that the entity that issued the notes had been experiencing cash-flow problems. The firm also failed to disclose that a company affiliated with the issuer was unlikely to be able to make its scheduled principal payments totaling $10 million that were due to its note holders in July 2009. Alternative Wealth violated FINRA Conduct Rule 2010, the SRO said.

✔ Distributed a research report in February 2010, but failed to disclose that a firm rep owned an interest in the subject of that report, **Terra Energy & Resources Technology, Inc**. Altenative Wealth also failed to disclose that the rep received compensation from Terra Energy. The broker-dealer was cited for violating FINRA Rule 2010 and NASD Conduct Rule 2711.

✔ Let its registered persons use PowerPoint presentations about Terra Energy to solicit potential investors at seminars. "The presentations contained statements and projections that were without basis, false, exaggerated, unwarranted and/or misleading," the settlement document said. The presentations also lacked material information about the risks associated with investing in Terra Energy, the Letter of AWC said. Alternative Wealth violated NASD Rule 2210 an FINRA Rule 2010;

✔ Failed to establish supervisory control P&Ps that tested the supervisory procedures to try to achieve compliance with applicable securities rules. For example, the procedures didn't identify producing managers and assign qualified principals to supervise them. For year-end 2008, the firm failed to do the annual CEO certification. It also failed to develop WSPs designed to comply with rules regarding private placements.

The firm didn't reply to a *BD Week* request for a comment.

Clements noted that to achieve adequate supervision under the rules, firms must have exception reports and a supervision system that: 1) reviews and approves in writing all products the firm sells; 2) ensures proper due diligence is conducted; 3) supervises all sales and marketing activities and documents suitability reviews on each c1ient; 4) provides adequate training for the sales staff and the supervisor, and 5) memorializes all sales and supervisory procedures in the P&P manual, and annually audits and tests the procedures as specified in the rules and in the manual.

"Clearly being a small firm like Alternative Wealth Strategies presented itself with supervisory issues that many small firms across the U.S. face today," he said.

Clements saw the combined CEO/CCO role as a problem. He also questioned how such supervisory deficiencies could go undetected for eight years. The firm was formed in November 2002.

Clements said firms should hire an independent compliance officer or hire a third party to review the firm's P&Ps annually, train sales and supervisory staff on products the firm wants to sell and business it wants to pursue, and to annually test the firm's procedures.

Uhlenhop said firms that have between about

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Alternative Wealth *(cont. from pg. 4)*

five and 25 reps can run into trouble if the CEO is the CCO because it can be too much work for one person to do both jobs. Yet such firms tend to be too small to support employing an individual CCO, he said.

Firms with fewer than five reps tend to be small enough for the CEO/CCO to be highly aware of what the reps are doing, he added.

"Once you're over 25, it's much more likely you're going to have a CCO who has experience and training. He may also be the CEO, but probably not," Uhlenhop said. "In the small firms where the CEO tries to do it, some people succeed in doing it because they have a strong, strong compliance background from being a CCO."

He added that FINRA is "less aggressive" with firms with fewer than five reps that have no problems with customers but that have limited supervisory procedures. In such instances, the regulator may tell the firm about the need to improve its record-keeping and supervisory procedures, but FINRA won't come down hard on the firm, he said.

"As long as the clients are being serviced properly, and they don't find other violations, I don't think you'll see a fine. You'll see a recommendation from FINRA, which will be pretty strong, that [the firm] improve their written supervisory procedures."

Lisa Roth, the CEO/CCO of **Keystone Capital Corporation** in San Diego, which has six reps and no branch offices, said the problems with Alternative Wealth weren't necessarily caused by the fact that the CCO was the CEO. She said 32 reps is a large number for a CEO/CCO to oversee, but what isn't known is how many principals there were to help watch over the reps.

She also said the firm had a limited business line, which would make it more feasible for one person to hold the CEO/CCO position.

"Some of the findings just look like sloppy compliance," she added.

"They're not getting the 3012 analysis down pat. If you're a CEO and the CCO, I believe you have to go out of your way to demonstrate that there's some objectivity in the firm's testing process," Roth said. "I really think you have to go out of your way to demonstrate that you've incorporated some modules, or mechanisms, or some transparency, or something to overcome the obvious conflict of interest, and that you're testing your own work. And I think for a CEO/CCO to fail in that regard, [it] jeopardizes the entire supervisory structure, which it looks like it did in this case."

Roth said at one point her firm had 12 reps and three branch offices. At that time, she employed a separate CCO, she said. ■

Due diligence tips you might want to consider for private placements

Noting that due diligence on private placements is crucial, here are some tips provided by **Michael Clements**, the co-owner and CCO of **Riverside Financial**, a start-up investment adviser firm and the owner of **Wall Street Consulting Services, LLC**:

✔ Review the firm's past, current, and historical values. "To just take the word of the firm on its face value or pursuant to the firm's offering memorandum would be negligent," he said.

✔ Visit the companies.

✔ Verify sales and revenues with customers.

✔ Contact the company's auditors.

✔ Speak with others who have invested in the company who are not affiliated. ■

FINRA fraud unit staying busy

FINRA has sharpened its focus on fraud, and from last year through October of this year referred more than 1,100 matters to the **SEC**, the self-regulatory organization's CEO, **Richard Ketchum**, said last week. Those referrals, from FINRA's Office of Fraud Detection and Market Intelligence (OFDMI), covered a range of issues, including insider trading, microcap fraud and Ponzi schemes, Ketchum said.

As an example, Ketchum noted that in April,

(Fraud, continued on page 5)

Fraud *(cont. from pg. 5)*

Joseph Mazella, the founder and President of a Staten Island-based real estate and consulting company — **Great Atlantic Group, Inc.** — was charged with securities fraud and money laundering. Mazella allegedly operated a $12 million Ponzi scheme from 2007 to 2010, Ketchum said. The charges resulted from the FINRA fraud-detection office referring information to the **FBI**.

Another example was the fraud-detection office referring information to the SEC that resulted in the discovery of a 20-year, multi-million dollar Ponzi scheme that victimized mostly law enforcement agents, Ketchum said.

"An analyst in OFDMI spotted red flags while conducting a routine review of a regulatory filing about a year and a half ago," Ketchum said.

"We expedited the review of the case and, because the fraud occurred through the firm's advisory business, we ultimately referred it to the SEC for investigation and prosecution within about 30 days of discovering the fraud."

Ketchum was addressing a gathering of people associated with the **Research Center on the Prevention of Financial Fraud** — a joint project of the **Stanford Center on Longevity** and FINRA's Investor Education Foundation. Among its goals is to collect research that identifies the causes of financial fraud and how to detect and prevent it.

The Center is using research from a wide range of fields — such as psychology, marketing, sociology, and economics — to help shape a practical response to financial fraud (see related story, pg.1).

Enhanced exam program

FINRA has enhanced its exam program and procedures to better detect conduct that could be a sign of fraud, Ketchum said. Exam teams will focus on areas at firms that are most likely to pose a risk to investors, he said. He noted that last year, FINRA created the Office of Risk that started the process to help FINRA identify high-risk firms, branch offices, brokers, activities, and projects.

"We are asking firms we oversee for more information to help us better understand their business models, including information about business activities, the types of products they sell and their customer base," Ketchum said. "This information will be used to better understand the risks that exist for individual firms and to tailor our regulatory responses to those risks."

Ketchum further noted that FINRA and the FINRA Foundation also have used "Investor Alerts," live events, and other methods to encourage investors to make wise decisions and to warn investors about things such as gold stock scams, fraudulent schemes that exploited the tsunami and nuclear crisis in Japan, and pre-IPO scams that purported to offer access to shares of Facebook.■

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