BD WEEK

Regulatory news and compliance best practices.

INSIDE...

February 28, 2011

Enforcement Alert

Make sure that sales-charge discounts for Unit Investment Trusts are applied

A couple of recently unveiled **FINRA** disciplinary cases provide a good reminder that you need to make sure that reps know about the sales-charge discounts that are available to clients who buy Unit Investment Trusts (UITs) – and that they apply those discounts.

FINRA fined **Cadaret, Grant & Co., Inc**. of Syracuse, N.Y., and **Chase Investment Services Corp.** of Columbus, Ohio, $125,000 and $100,000, respectively in separate settlements related to UITs. Both firms were found to have supervisory failures that resulted in some clients who purchased UITs not getting the discounts to which they were entitled, according to the Letters of Acceptance, Waiver, and Consent.

In both cases, "breakpoints" and "rollover and exchange" discounts on sales charges weren't always

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AML tips include being open-minded about varied exception reports

Don't be "myopic" when it comes to the exception reports you could order from your clearing firm, a senior **FINRA** staffer says. Although you might not initially realize it, some of those reports might help you identify suspicious activity that could be detected under your anti-money laundering program.

That was one of several AML best practice tips shared during the recent *CCOutreach BD* program in Washington.

Your arrangement with your clearing firm might enable you to get exception reports that fall outside what you usually associate with AML, but some of

(AML tips, continued on page 2)

Cost basis reporting rule kicks in

Remember that this is the year you're supposed to start reporting to the IRS, and to your customers, the cost basis for transactions your firm made on the customer's behalf.

The **IRS** has expanded the 1099-B form 💻 this year to enable you to make those entries.

The form also will be used to report whether the gain or loss on those transactions is long term (meaning they were held for more than one year) or short term (held a year or less), according to the IRS.

Under the rule, covered securities include all stock acquired beginning in 2011 "except stock in a regulated investment company for which the average basis method is available and stock acquired in connection with a dividend reinvestment plan, both of which are covered securities if acquired beginning in 2012," the IRS says. Cost basis reporting for options will start in 2013.

Michael Clements, president of Florida-based

(Cost basis reporting, continued on page 4)

AML tips *(cont. from pg. 1)*

those reports could come in handy on the AML front, said **Michael Rufino**, chief operating officer, FINRA Member Regulation Sales Practice.

A "velocity report" on the amount of wires going in and out in a given time period could help you judge whether there's so much activity in an account that it's a cause for concern, Rufino said.

Third-party wire reports can be used to help you comply with FINRA's rule on notification, but also can be used for AML purposes, he added.

Employee trading reports might come in handy when it comes to spotting possible insider trading, which is one of the reportable items on Suspicious Activity Reports, Rufino said.

Also consider inactivity reports, changes in investment objectives, and low-price securities, he added.

Clearing firms are obligated under NASD rule 3230 to annually notify their correspondent firms' CEOs and CCOs about what reports are available to them and which ones the correspondent firm is receiving.

On an annual basis, consider whether your business model has changed, warranting a change in the selection of reports you receive, Rufino suggests.

Delineation of duties

The agreement you have with your clearing firm needs to clearly delineate which AML functions the clearing firm will perform versus the ones you will perform, Rufino said. A frequent problem FINRA examiners find is that the introducing firm didn't carry out certain responsibilities because the firm wasn't aware enough of what was in the agreement.

Is clearing firm fulfilling its obligations?

Even if you know which firm does which AML duties, make sure the clearing firm is doing what it says it is doing, says **Mark Cresap**, president and owner of the broker-dealer **Cresap, Inc.**, headquartered in Radnor, Pa. For instance, if the clearing firm is supposed to send clients change-of-address forms, or documents about investment objectives, make sure the clearing firm is doing that, said Cresap.

Among other tips suggested by the AML panel:

Training

To keep training "fresh" and relevant, use factual scenarios that have occurred during your day-to-day work, being careful to protect the innocent, said **Jeff Halperin**, vice president and chief compliance officer at **MetLife**, whose four broker-dealers have about 10,000 reps.

Make sure the training is auditable. Automated e-mail follow-ups can come in handy here, Halperin said. To boost training-completion rates, openly reveal the rates of the various business units during meetings of managers and higher-ups. People don't want to look bad in the eyes of peers and supervisors, so they will strive to do well, Halperin said.

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AML tips *(cont. from pg. 2)*

Customer due diligence

Customer due diligence should be very thorough at account opening because so much of the process downstream deals with identifying deviations from what's normal for that customer, he said. He adds that he accepts only those accounts that are totally transparent. His message to his reps and staff is to "question virtually everything." For instance, "double and triple check third-party wires," and make sure the letter of authorization is present with the original signature. "That would seem to be an area where most firms might get tripped up," he said.

He also steers clear of foreign accounts.

Also be very wary if it appears that an investor is searching out a small firm because the investor thinks the firm might have a lax compliance structure, Cresap said.

How one pro hit the ground running

When starting at a firm, you might want to consider some of the steps taken by **Joseph Hanvey**, executive director and AML compliance officer of **Nomura Securities international, Inc.**, an Asian investment bank with more than 30 jurisdictions that's also an institutional BD.

Upon starting in June, Hanvey set up about 20 meetings with "stakeholders," including people in audit, legal, the line of business supervisors, and others such as anyone who originated client accounts from an operations standpoint. He looked at all audit reports, SAR filings, and policies. He wanted to see whether the firm was identifying the reportable events, whether it was reporting them, and what the case management system looks like.

He looked at several customer accounts, and reviewed the due diligence forms for those accounts because he wanted to see whether reps were doing the appropriate paperwork, he said.

Hanvey wanted to get into pivot tables and identify what kind of clients the firm had. For instance, he wanted to see whether some of them were foreign financial institutions.

He met with the boss and wanted to understand the firm's exposure. Instead of conducting an AML risk assessment, he created a "threat matrix" that could help identify threats to the organization from internal forces such as employees and affiliates, and external threats. He wanted to know whether some of the entities they were dealing with were unregulated, such as hedge funds.

He then met with stakeholders and determined which areas they got right and which areas needed addressing.

The matrix showed where controls should be built, he said. For instance, there was one line of business that had a new product and a new branch office, and was bringing on clients that might be high-risk because they were from a high-risk jurisdiction. To address that potential threat, the firm created a six-person due diligence team.

Among the elements to consider incorporating into a threat matrix are Patriot Act Section 311 Special Measures that may have been withdrawn but that provide a useful description of a certain jurisdiction and the Transparency International Corruption Index, Hanvey said.

The firm also created a committee that meets monthly with lines of business and reviews all high-risk accounts, he added.■

Detail suspected financial abuse against elderly clients on SARs

If you suspect that an elderly client might be a victim of financial exploitation, file a Suspicious Activity Report indicating that, and include the term "elder financial exploitation" in the narrative portion of the SAR, says the **Financial Crimes Enforcement Network.**

The instructions are in an advisory that FinCEN issued last week 💻.

The narrative also should explain why the activity is suspicious, FinCEN says. But when filling out the form, be careful that you don't report the potential victim as the subject of the SAR, the agency warns. All available information about the victim should be included in the narrative portion of the SAR.

Firms can learn about possible elder financial abuse through monitoring transactions and through their direct interaction with elderly customers,

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SARs *(cont. from pg. 3)*

FinCEN notes. Among the possible red flags that could indicate a problem:

✔ Debit transactions that are inconsistent for the customer;

✔ Uncharacteristic attempts to wire large sums of money;

✔ Closing of CDs or accounts without regard to penalties;

✔ A caregiver or other person showing excessive interest in the client's finances or assets, and who doesn't let the client speak for himself or herself;

✔ The client showing an unusual degree of fear or submissiveness toward a caregiver, or expressing a fear of eviction or nursing home placement if money isn't given to a caretaker;

✔ The inability to speak directly with the client despite repeated attempts to contact him; and

✔ The client's financial management changes suddenly, such as through a change of power of attorney to a different family member or a new individual.

FinCEN hopes to get a picture of the kinds of abuse that are occurring in various parts of the country through the SAR filings, said agency spokesman **Bill Grassano**.

Many firms might not think of reporting elder financial abuse on a SAR because many see it more as fraud than as AML, said **Alan Sorcher**, leader of the **Deloitte Anti-Money Laundering Strategic Leadership Group**.

But he noted that FinCEN has distributed other alerts —mentioning red flags to watch for — on topics similarly associated with fraud such as mortgage fraud and foreclosure rescue schemes.

But Sorcher added that "fraud is a predicate to money laundering." ■

Note to readers

All *BD Week* articles, dating back to October 1998, are available at **www.BDweek.com**. Articles are full-text searchable and indexed by topic. ■

Cost-basis reporting *(cont. from pg. 1)*

Wall Street Consulting Services, LLC, said, "The cost-basis IRS reporting mandate will at best be challenging, in the early stages of 2011. Firms, banks and other financial intermediaries will initially be burdened with costs, system upgrades and additional compliance audits to ensure that the shift from proceeds reporting to cost basis reporting is done properly."

Among the challenges that firms will face over the three-year implementation period are ensuring all the required securities are included, how to deal with tax information in accounts of customers who transferred assets, wash rule adjustments, foreign account issues, treatment of mutual funds and grandfathered holdings, he said.

"I understand that the IRS wants to combat annual capital gains underreporting. But they must realize, in their attempt to capture greater tax revenues, they are putting an unnecessary financial burden on the securities industry members with no benefit to them," he said.

Firms will have to eat the cost of the new reporting requirement, which helps the IRS do its job and keeps customers honest, Clements added.

The new rule was included in the Emergency Economic Stabilization Act. ■

UITs *(cont. from pg. 1)*

applied, FINRA found. The issues occurred between September 2006 and June 2008.

UIT breakpoints generally operate as a sliding scale where discounts are available for purchases beginning at the $25,000 level and at the $50,000 level, FINRA noted.

The issue of UIT sales-charge discounts was addressed in NASD Notice to Members (04-26 💻). The self-regulatory organization said the same requirements that call for firms to notify customers about breakpoint discounts in front-load Class A mutual funds apply to sales of UITs.

"NASD considers it essential that sales of UITs be affected on the most advantageous terms available to the customer," the notice says. "It is the responsibility of firms to take appropriate steps to ensure that they and their employees understand, inform

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UITs *(cont. from pg. 4)*

customers about, and apply correctly any applicable price breaks available to customers in connection with UITs."

The SRO also emphasized that firms must train their employees on these discounts, and train them to correctly process every transaction in a way that "promotes and ensures delivery of all promised commercial terms of an investment or product, including any applicable discounts to pricing, commissions, fees, or spreads."

Tip: In addition to training personnel on the discounts, require reps who sell UITs to indicate on a check-off box on a form whether the rep informed the customer about the discount, suggests **Kurt Schafers**, a partner at **Cosgrove Law, LLC**, which is based in St. Louis.

Supervisory failures at Cadaret

FINRA said that at Cadaret, a review of a sample of customer purchases in certain top selling UITs found that the firm failed to identify, and appropriately apply, sales-charge discounts in about 4.4% of those sampled transactions. As a result, certain customers were overcharged, FINRA said.

Cadaret didn't have written policies or procedures that addressed UITs or that informed reps, trading personnel, or supervisors about sales-charge discounts for UITs, FINRA said. It relied on its trading desk to make sure clients buying such products received appropriate discounts, even though the firm didn't adequately train employees and reps about the discounts, according to FINRA.

Cadaret also had no supervisory review — either through periodic reviews or exception reports — to determine whether trading personnel were providing the appropriate discounts, FINRA said.

The firm also was unaware that its UIT trading desk was misinterpreting certain rollover provisions described in the prospectuses, FINRA said.

Supervisory failures at Chase

Chase relied mainly on brokers to make sure customers received the appropriate discounts even though the firm failed to appropriately inform and train them and their supervisors about those discounts, FINRA said.

Before 2008, Chase's manual for registered reps contained no information or guidance about UITs. But in January 2008, the manual made a reference to UIT breakpoints but there was no information about rollovers or exchanges, FINRA said. And from September 2006 through June 2008, there were no written procedures for supervisors regarding UIT sales-charge discounts.

In a sample of customer purchases in certain top selling UITs, Chase failed to identify and appropriately apply sales-charge discounts in about 1.7% of the transactions reviewed. Because of that, customers were overcharged about $13,700, FINRA said.

Both firms — Chase and Cadaret — failed to include a deferred sales charge legend on UIT confirmations, which was a rule violation, FINRA said. ■

Zipping file might help you meet FINRA encryption standard, SRO says

Your computer's software might be able to encrypt an electronic file that meets **FINRA's** standard by zipping it, the regulator said in a recent podcast. But if the software has an encryption function for files that are compressed in this manner, the encryption must be at least 256 bits.

Remember, under a rule change that took effect this year, electronic information you send FINRA on a portable media device in response to a Rule 8210 information request must be encrypted.

When sending the file to FINRA, the "key" should be sent in a separate communication, FINRA officials emphasized.

And *all* electronic information on the device must be encrypted, even if none of it is personal information, officials reminded.

Some desktop platforms allow you to password-protect a document but that isn't necessarily the same as encrypting it, the officials warned.

Strong passwords

And use "strong passwords," FINRA recommends.

Microsoft says that when possible, use a

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Encryption *(cont. from pg. 5)*

password that's at least 14 characters, and the greater the variety of characters, the better. It also recommends using the entire keyboard, and not just those characters you see most often.

It also recommends that you avoid using passwords that can be found in the dictionary of any language, as well as words spelled backwards, abbreviations, and characters that are in sequence or frequently repeated.■

Rule clarifies definition of 'foreign' account that must be reported to IRS

The requirement for U.S. citizens to report the existence of foreign financial accounts to the **IRS** *does not* apply to the securities of a foreign company being held at a U.S. firm, the **Financial Crimes Enforcement Network** clarified last week.

FinCEN issued a final rule on February 24 clarifying a number of things regarding Reports of Foreign Financial Accounts—Form TD—F 90-22.1 (FBAR), and one of the key things was when an account is considered "foreign."

"FinCEN wishes to clarify that, as a general matter, an account is not a foreign account under the FBAR if it is maintained with a financial institution located in the United States," the rule says.

"For example, individuals may purchase securities of a foreign company through a securities broker located in the United States as part of their investment portfolio."

"The mere fact that the account may contain holdings or assets of foreign entities does not render the account 'foreign' for purposes of the FBAR."

"In this instance, the individual maintains the account with a financial institution in the United States."

FinCEN said a proposed version of the rule had prompted a large number of comments asking for clarification on this point.■

Additional Labor Department pension disclosures pushed back to next year

The **DOL** has decided to move the effective date of the new ERISA disclosure rule from this July until next January. The new rules would require certain service providers of employee pension plans to disclose data to help plan fiduciaries understand whether fees being charged to the plans are reasonable as well as to assess potential conflicts of interest.

The department wishes to make sure it gets the rules right by more fully reviewing industry comments, "including suggestions for a summary document to further assist plan fiduciaries in their review of furnished information" from service providers, according to the agency. The new effective date is Jan. 1, 2012.■

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