BDWEEK

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January 3, 2011

Movement toward fiduciary standard, conflicts disclosure among 2011 issues

Activity around a fiduciary standard for BDs is one of the leading topics looming for the year 2011. "It's been made clear the **SEC** intends to move forward in creating this new fiduciary standard" for broker-dealers, says **Joan Hinchman**, CEO of the **National Society of Compliance Professionals**.

David Tittsworth, executive director of the **Investment Adviser Association**, says it's difficult to predict what the SEC will say in its report due out this month about the obligations of broker-dealers versus investment advisers. But he said there's widespread belief that the SEC eventually could mandate some type of fiduciary standard for BDs. "I

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Groups say FINRA is moving too fast on disclosure document idea

A group that represents compliance officers says some of the provisions in **FINRA's** early-stage proposal to require firms to disclose conflicts and other information at the start of a business relationship are fraught with problems.

In addition, that group, the **National Society of Compliance Professionals**, is in synch with **SIFMA** in arguing that FINRA jumped the gun with its proposal. They say FINRA should wait until the **SEC** releases results of its study on the obligations of broker-dealers versus investment advisers this month or even wait until later.

The SEC's congressionally mandated study is expected to fuel the Commission's movement toward requiring some type of fiduciary duty standard for BDs that give investment advice to retail customers.

The comment period just ended regarding the

(Disclosure document, continued on page 4)

Enforcement Alert

FINRA case illustrates steps to take to improve AML program

A recent **FINRA** settlement with a firm accused of failing to adequately implement an AML program offers a chance to look at what steps to take to substantially upgrade AML performance.

Fined $150,000 was the Miami-based broker-dealer **Global Strategic Investments LLC.** FINRA says that in several instances, Global — acting through associated person **Cesar Hernandez** — failed to detect, analyze or report highly suspicious transactions, or to implement an adequate customer identification program from January 2007 through April 2009.

Hernandez, who has held various positions with the firm since May 2001, including CEO, CCO, and AML compliance officer, was fined $25,000 and suspended from serving in a principal capacity for three months, starting Nov. 15, 2010.

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think most people think the SEC will split the baby in some sense, that it's probably not just going to be all the Advisers Act fiduciary duty, or the status quo, it'll be something in the middle, but I think it's pretty hard to predict."

"I think it will certainly be proposed," says **Michael Koffler**, a partner in the New York office of **Sutherland**, who wrote a white paper on the fiduciary topic for the firm **Envestnet**. But even if adopted in 2011, the compliance date likely would be the latter part of 2011 or later, Koffler says. "One would think there would be a healthy lead-in time."

Lisa Roth, the CCO and CEO of **Keystone Capital Corporation** and an active member of the **National Association of Independent Broker Dealers**, says she thinks the SEC will issue the fiduciary duty rule this year.

Here are a few comments from knowledgeable industry players about other developments likely on the horizon in the year ahead:

✔ **Point of business contact disclosure for BDs — FINRA's** concept proposal (Regulatory Notice 10-54), would require BDs to give new customers an ADV-type disclosure document about services, fees, and conflicts (see related story, pg.1). "I don't think that's going to go anywhere in its present form, but it's a shot across the bow," Koffler says. He thinks the proposal will be changed a great deal.

Roth says FINRA's concept for the proposal is "great," but as currently written, it "doesn't do one thing to help investors," and would just provide "a heyday for consultants and attorneys and regulatory examiners." She hopes, instead, that FINRA takes some of the information it already has in its systems — such as some of the information in Gateway — and puts it in a format that's interactive and that lets investors see it.

✔ **SEC's whistleblower proposal** — The controversial proposal, if finalized, would pay money awards to whistleblowers who voluntarily provide original information about securities law violations. To get the award, tips would need to lead to the SEC getting at least $1 million in sanctions. If finalized, firms would need to craft policies and procedures that reflect the provisions and also educate staff about the provisions, Hinchman says.

Tittsworth notes that the SEC has delayed creating the formal office of the whistleblower until Congress frees up money for it. The new Congress is expected to be more fiscally conservative.

As to whether the new Congress might scuttle major provisions of the Dodd-Frank financial reform law such as the whistleblower program, Tittsworth says, "I think that the odds that the new Congress is just going to come in and repeal large chunks of Dodd-Frank is highly improbable."

"I do think that the new Republican leadership in the House is likely to convene a number of hearings. I think those hearings will focus on a variety of provisions in Dodd-Frank … whistleblower could be part of that, [the idea of an] SRO [for investment advisers] could be part of that, derivatives certainly could be part of that, the Volcker rule could certainly

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be part of that, but I think it's pretty hard to predict."

✔ **Regulators getting into new areas —** Some firms might need to get used to regulators with new authority, such as the **Municipal Securities Rulemaking Board,** that could affect day-to-day compliance regimes, Roth says. She also notes that FINRA is "angling hard to get oversight of investment advisers," and states could be stepping up their authority. California, she notes, now requires third-party marketers to register as lobbyists. Small firms might need to get more connected with trade organizations to stay abreast of the regulatory changes taking place, Roth says.

✔ **Arbitration** — There's a possibility that mandatory arbitration for broker-dealers could be done away with, Koffler says.

✔ **DOL regulations** — Broker-dealers that provide investment advice to employee benefit plans and individual retirement accounts could fall within a new, broadened definition of ERISA fiduciary. "There are a lot of questions on the BD side," Koffler says. He says it will be interesting to see how BDs that are classified as fiduciaries under the regs deal with the restrictions that come with that classification.

✔ **Blowups ahead and risky products** — "The things that are likely to blow up are the instruments that have historically been considered safe, which, because of the economic environment, are no longer safe," Hinchman says, emphasizing municipal securities. "I think we'll be seeing some municipalities defaulting," she adds. She also says that sovereign foreign debt used to be considered safe but now "it's an increasingly risky instrument."

More investors might be approached with complex instruments. "I'm sure this is on FINRA's mind: There'll be generally a desperate search for deals. And what people should be watching for is the increase in offerings of complex derivative instruments with lots of leverage. The baby boom generation that is retiring, they're most susceptible," Hinchman says.

She says the sales force will look to the baby boomers for transactions. "The question will be, will the baby boomers understand what they're getting into when they fall prey to 'chasing the yield'?" Hinchman adds that: "With the new products hard times inspire, firms will need to increase their due diligence efforts, as well as their educational offerings to be certain their sales force understands what they're selling." ■

Compliance groups seek change in SEC whistleblower proposal

Among the last bunch of written comments the **SEC** received on its proposed whistleblower rule are several from those representing business and compliance interests who say whistleblowers should have to first report wrongdoing to effective, internal compliance programs before being eligible for the SEC's award program.

Otherwise, they argue, the program will undercut internal compliance programs.

The proposal doesn't require internal reporting first, with the logic that whistleblowers need an outside avenue to report if they fear retaliation, or if they think the internal program will be ineffective.

The proposed regulations "offer substantial financial incentives for employees to bypass internal mechanisms and go directly to the SEC," said a letter representing some of the largest global companies in the U.S., including **Alcoa**, **Citigroup**, **Intel Corporation**, **JPMorgan Chase & Co.**, **Prudential Insurance Company of America**, and **Kraft Foods**.

Similar sentiments were expressed by the **Business Roundtable Institute for Corporate Ethics**, the **National Society of Compliance Professionals**, **The Institute of Internal Auditors**, and the **Society of Corporate Secretaries & Governance Professionals**.

The program, the groups argue, should *encourage* the use of internal compliance programs as opposed to merely trying to avoid *discouraging* their use.

The proposed program would allow the SEC to grant money awards to those who voluntarily provide original information about securities law violations. To get the award, those tips would have to lead to successful enforcement actions where the SEC gets at least $1 million as a result of sanctions. The whistleblower would get 10% to 30% of the sanction.

Among the other points made:

(Whistleblower, continued on page 4)

Whistleblower *(cont. from pg. 3)*

✔ If the SEC insists on allowing whistleblowers to go straight to the Commission, there should be clear-cut factors that reduce the amount of the award the whistleblower ultimately gets, said the NSCP.

✔ Lengthen the 90-day grace period the proposal provides whistleblowers to report information to the **SEC** after first reporting it internally. Compliance programs will need more time to investigate the allegations, they said. The NSCP says the time period should be longer, and the rule should give the SEC the discretion so that firms have a "reasonable" amount of time to deal with the problem. The Business Roundtable suggested lengthening it to 180 days.

✔ The NSCP said the SEC should expand the categories of those who generally would be ineligible to be whistleblowers to also include employees in the areas of operations, finance, technology, credit, risk, and similar areas who perform control functions that are mainly related to compliance. These functions would include supervision and monitoring.

✔ The coalition of large companies said under no circumstances should an employee with compliance or similar functions be eligible to become a whistleblower. (The proposal allows an exception if the whistleblower thinks the employer is acting in bad faith or not reporting the problem to the Commission in a "reasonable" amount of time.

✔ Individuals should be ineligible if the information provided to the SEC is already related to an internal investigation underway, the NSCP suggested. ■

Disclosure document *(cont. from pg. 1)*

concept proposal FINRA issued in October (Regulatory Notice 10-54). That proposal sought industry views on the idea of requiring BD's to give retail investors an ADV-type document that would disclose the firm's services, payment incentives, fees, and conflicts (*BD Week*, Nov. 1, 2010).

The five elements in the disclosure would include: 1) the types of accounts and services the firm provides; 2) disclosures designed to enable customers to "evaluate" the firm (e.g. the fees associated with each brokerage account); 3) disclosures of financial or other incentives for recommending certain products or strategies; 4) disclosure of conflicts that may arise between a firm and its customers; and 5) limitations on the duties the firm owes its customers.

The NSCP says it applauds enhanced disclosures but it also sharply criticized various aspects of the proposal as unclear and having the potential to pose huge burdens on firms. And SIFMA argued the proposal is so premature it wouldn't be "cost-effective or useful" to submit detailed comments now, so it submitted a slimmed-down version and plans to add more later.

SIFMA and NSCP added that FINRA's plan, if it isn't slowed down, could result in FINRA and the SEC issuing conflicting disclosure rules if the SEC decides to require the fiduciary standard for broker-dealers. NSCP recommended that it's "prudent for FINRA to delay rulemaking until the SEC promulgates final rules" about the fiduciary standard. "Investors are not harmed by this delay," it added.

(When FINRA issued the release, it said there's no need to wait for the SEC to issue its study or its rule on fiduciary duty because the Dodd-Frank financial reform law "requires the SEC to facilitate simple and clear disclosures of material conflicts by both broker-dealers and investment advisers.")

Among the criticisms and recommendations NSCP made regarding the concept proposal:

✔ The disclosure statement FINRA envisions is "overly broad" because it would treat all BDs alike, despite there being differing business models, such as firms that exist purely as a distributor for a mutual fund company.

✔ Some provisions would replicate what a firm already does. Publishing a summary of the services the firm provides appears to be "redundant without substantial benefits to clients," NSCP said.

✔ Publishing the scope of services the firm provides retail customers could be "unduly burdensome" because of the wide variety of products available at BDs and the latitude they have in defining the scope of individual products (such as levels of options trading).

✔ FINRA should study investors' needs and create a model disclosure format to be used by firms. The idea of a study also was suggested by the **Financial Services Institute**, which sent a note to its members urging them to make that point and others when writing to FINRA.

(Disclosure document, continued on page 5)

Disclosure document *(cont. from pg. 4)*

✔ FINRA's idea of requiring firms to disclose *all* fees associated with each brokerage account can pose a real problem, the society said. "Rate schedules for many firms can be quite detailed and extensive," NSCP said. Another problem, it added, is that the requirement might have a competitive impact on many firms that don't currently publish their fee and rate schedules, especially commission rates. If the SEC and FINRA insist on such disclosure, they should standardize the types of fees that are disclosed and how they are presented so that investors could compare firms, NSCP said. It also suggested that FINRA could publish these fees on its web site.

✔ If the document can be presented to clients in an electronic format, that would help firms save money and enable them to be updated quickly, NSCP said. SIFMA and the FSI also suggested allowing firms to offer the documents electronically, unless clients want hard copies.

✔ The three organizations suggest having a tiered approach in which a general, streamlined version of the document can be provided to the customer, who could then request a more detailed version if desired.

✔ The documents should be updated annually, both NSCP and SIFMA suggested.

✔ FINRA will need to clarify whether the document would be subject to its advertising rule requirements, the NSCP said.

✔ FINRA should clarify that the document be presented at the time the person becomes a client, or no later than 10 business days after the person becomes a client, NSCP said. The current phrase, it argued, is vague because it says the document should be provided "at or prior to commencing a business relationship with a retail customer." ■

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

FINRA said the amount of the fine against Global reflects "the significant remedial efforts undertaken by the firm."

Corrective action taken

Part of the corrective action Global took was to bring in new leadership. It named a new chief executive officer, **Lionel Baugh**, and a new chief compliance officer, **David Mahler**, according to a statement Global attached to FINRA's Letter of Acceptance, Waiver and Consent.

Mahler, an attorney with 30 years experience in the securities industry, including positions with some of the biggest firms, will be responsible for Global's AML compliance program. Last week, he declined to comment about the changes the firm is making, noting the difficulty of getting clearance to comment during a holiday week.

But the firm's letter of correction explains some of those changes, which include contracting with the accounting firm **KPMG** to conduct a "lookback" of the firm's wire, check and journal activity to determine whether any unusual or potentially suspicious activity hadn't been previously identified. Global voluntarily gave FINRA a copy of the accountant's report on its findings.

FINRA said that as a result of the lookback review, which started in 2008, the firm ended up filing about 46 Suspicious Activity Reports.

Among other corrective actions the firm took:

✔ Contracting with KPMG to review Global's AML policies, procedures and processes to ensure compliance with rules, regulations, and industry best practices and to help implement certain internal controls;

✔ Implementing a number of computerized compliance tools to help with AML compliance, including Worldcompliance software for OFAC/PEP screening.

✔ Bolstering AML training for firm employees.

Best practices tips

Here are some tips to keep in mind when upgrading an AML program suggested by **Michael Clements**, the CCO of a hedge fund who also runs **Wall Street Consulting Services**, which is in the network associated with **Bekker Compliance Consulting Partners**:

✔ Look back at how the firm's exception-reporting system has performed to see whether it's picking up the transactions it's supposed to pick up. Test the system by putting in transactions that should be flagged.

✔ Update AML/BSA policies and procedures to ensure they reflect AML regs and FINRA's Rule 3010

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AML program (cont. from pg. 5)

provisions calling for supervisory procedures to be tested and updated if needed.

✔ Verify the source of assets for foreign customers, Clements said. "In many instances, they need to verify the assets, which means if a customer says I received this million dollars from a relative who passed away, it might be smart – because of the origination of the assets – to say, 'Fine, can you please send me a copy of the will or something demonstrating the transfer of the estate to that person?' That's something that's overlooked a lot," Clements said.

✔ Ask about the movement of money between relatives' accounts, such as money moving from a husband's account in one bank to a wife's account at another bank, and then back into a brokerage account. "Questions need to be asked to the customer …. 'Why are you transferring the money in, moving the money to another relative, buying a security on Monday, selling the security a week or two later, and then transferring the money back out to another bank?' They need to ask questions, which is not done," Clements said.

✔ Document the responses you get when you ask about suspicious activity. Send a confirming letter to the customer about that conversation, with a statement at the end that asks the customer to contact you immediately if anything in the letter is incorrect. "The only protection that a firm has is in the investigations and documentation that they keep," Clement says.

Global Strategic Investment violations under Hernandez

FINRA said that Global and Hernandez didn't identify and analyze "numerous" transactions to determine whether they were suspicious, despite firm policies directing them to do otherwise.

In many instances, according to FINRA, Global and Hernandez let foreign customers deposit funds into their accounts and within days or weeks disburse them from their accounts to first and third-parties, and, in some cases, in amounts slightly below $10,000.■

Firm ousted over mark-ups; former president and a rep are barred

FINRA has expelled an Austin, Texas-based firm, barred its former president, and barred a rep in a settlement involving a series of excessive mark-ups that in several instances exceeded 10% and in one instance was 67%. Expelled was **APS Financial Corporation**. Barred was former president **George Conwill**, and rep **Peter Kenneth Aman**. Among the firm's victims was a man who's at least 89 years old who was overcharged by $1.2 million, FINRA said.■

BD Week is taking its scheduled winter break. The next issue of *BD Week* will be e-mailed on Jan. 14, 2011.■

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