BD WEEK

Regulatory news and compliance best practices.

INSIDE...

January 17, 2011

FINRA's new suitability and KYC rules broadcast examiners' focus areas

FINRA's new suitability rule, in essence, provides a checklist of what an examiner would expect regarding information you collect about clients to determine product suitability. The rule takes effect Oct. 7, along with an updated know-your-customer rule.

The suitability rule (rule 2111) lists the types of customer information you must try to collect to determine suitability profiles of clients. If you don't have some of that information, you must document why it isn't essential.

Among the types of information sought are financial situation and needs, investment objective,

(Suitability and KYC, continued on page 2)

Enforcement Alert

Technology reveals multiple changes in customer contact info; catches rep

Consider implementing a program that alerts branch office managers when a rep makes a substantial number of changes to client records – such as lots of changes to clients' telephone numbers.

Such a system helped **UBS Financial Services, Inc**. detect that a rep in its Beverly Hills branch office changed 28 customers' phone numbers, resulting in incorrect contact information for 76 customer accounts, according to **FINRA**.

The rep, **Junior Kim**, changed the numbers after he and other members of a rep team to which he belonged planned to leave UBS and take a job with another firm, FINRA said.

Upon learning of the altered records through its technology, and investigating, UBS terminated Kim over a year ago, but the FINRA case against him

(Customer contact info, continued on page 5)

Due diligence on IAs must be performed before relying on their CIPs

If you want to rely on an investment adviser's customer identification program for those clients it refers to you, you're going to need to perform due diligence on that firm and their customer base, says a new **SEC** no-action letter that takes effect in May and will last through the beginning of 2013.

But be warned that the SEC ultimately will hold you responsible if it finds problems with your accounts that are caused by a shortfall of the IA's AML program, warns **Michael Clements**, president of Florida-based **Wall Street Consulting Services, LLC**.

The new letter augments the general requirements of a no-action letter that was set to expire last week but will be extended through May 11. After that, the new version takes hold.

The new version, dated Jan. 11, states that due diligence will need to be updated "as appropriate."

(No-action letter, continued on page 3)

Suitability and KYC *(cont. from pg. 1)*

investment time horizon, investment experience, liquidity needs, risk tolerance, age, tax status, and other investments.

"It's much more defined and I think that it gives the examiners a roadmap to look for that now," says **David Sobel**, executive vice president and CCO of **Abel/Noser Corp**., a New York City-based broker-dealer. "So now, they're going to look for it. If you haven't been doing it, you better start doing it. And if you have been doing it, you better document it."

Another new wrinkle in the suitability rule is coverage of investment strategies involving securities. This goes beyond the old focus on the suitability of transactions, says **David Thetford**, a securities compliance principal analyst at **Wolters Kluwer Financial Services.** Recommended strategies are covered even if those recommendations don't result in transactions, FINRA says. Excluded from this are educational materials that don't recommend a particular security.

In terms of the know-your-customer rule (rule 2090), the language is more "qualitative" than in the past, Thetford says.

The new KYC rule calls for "essential facts" needed to service the customer's account, follow special handling instructions, understand the authority of those acting on behalf of the customer, and comply with rules and regulations. It is more principles-based than the rule it is replacing, Thetford adds.

It could take firms time to figure out what to gather to satisfy the KYC rule, and the information might be learned as a result of complaints, litigation and settlements, Thetford adds.

(Note: FINRA states that firm KYC information and suitability information should be periodically updated, but stopped short of specifying a time period during which updates should occur. It noted, however, that Exchange Act rule 17a-3 calls for BDs to try to update certain account information every 36 months regarding accounts for which the BDs were required to make suitability determinations.)

Timing of rule

Thetford says it would have made more sense for FINRA to hold off on issuing the suitability and know-your-customer rules until after the SEC released its studies on whether BDs should be held to a new fiduciary standard and whether there should be a self-regulatory organization for investment advisers. The result of what the SEC does could affect the standing of these new FINRA rules, he said.

"It sort of seems to me [that], between these two rules, and the Regulatory Notice 10-54 [which proposes an ADV-type disclosure document for BDs] that maybe FINRA is continuing to maneuver for a position as an investment adviser SRO," Thetford says.

FINRA said in Regulatory Notice 10-54 that it was unnecessary to wait for the SEC's study on whether there should be a fiduciary duty for BDs because "staff determined that no matter how the ultimate contours of such a standard would be

(Suitability and KYC, continued on page 3)

Suitability and KYC *(cont. from pg. 2)*

concluded, retail customers would benefit from an upfront disclosure document that sets forth in plain English a firm's accounts and services, its associated conflicts of interest and any limitations on duties owed to the customer."

It also said the Dodd-Frank reform law "requires the SEC to facilitate simple and clear disclosures of material conflicts by both broker-dealers and investment advisers."

And Sobel noted that FINRA CEO **Richard Ketchum** has indicated he is in favor of a fiduciary duty standard – and that Ketchum wants FINRA to be considered for an SRO for investment advisers. As for fiduciary duty for BDs, Sobel says, "any broker who thinks he's not already under a fiduciary duty is just kidding himself because when you go into an arbitration the first claim is breach of fiduciary duty."■

SIFMA says some IAs should have an SRO if regulation is to be 'comparable'

Days before the **SEC** was scheduled to release its recommendations on whether there should be a self-regulatory organization for investment advisers, **SIFMA** officially weighed in on the debate. An SRO for IAs who deal with retail customers would be necessary if IA regulation is to be "comparable" with BD regulation, said SIFMA's Senior Managing Director and General Counsel **Ira Hammerman**.

The question of whether an SRO is needed for IAs, which is raised in the Dodd-Frank law, should be addressed in light of the possibility of a uniform fiduciary standard being applied for BDs and IAs when providing personalized investment advice to retail customers, Hammerman said in a Jan. 12 letter to the Commission.

On Jan. 18, the SEC is expected to release its congressionally mandated study on the question of an SRO for IAs.

"An important component of holding these intermediaries to a comparable standard of care is ensuring effective oversight of these activities," Hammerman said. "Oversight of broker-dealers is bolstered by the examination and enforcement activities of SROs with respect to the broker-dealer's conduct regarding their customers and, in particular, their retail customers."

He said that in light of harmonization, BDs and IAs should be subject to "comparable examination and enforcement, which appears to be practically and readily achievable through use of an SRO…."

The SEC should continue to oversee IAs that serve institutional customers but an SRO should oversee those IAs with retail customers, he continued. He said most retail IAs that aren't affiliated with BDs are small, independent IAs. Due to their small size, he said, "many do not have substantial legal and compliance departments to monitor for compliance with applicable regulatory standards."

He also said:

✔ An SRO exam program should be carefully tailored to IA practices and

✔ If more than one SRO is developed to examine IAs, dually registered firms should have the option of selecting a single SRO that oversees both the firm's BD and IA functions when it comes to providing personalized investment advice to retail customers.

The **North American Association of Securities Administrators** has come out against the idea of an SRO for IAs, stating that the SEC can do the job if the Commission gets the additional resources it needs.■

No-action letter *(cont. from pg. 1)*

New language

This due diligence language is new. Under the old letter, BDs could rely on IAs' CIP only if it was "reasonable under the circumstances," the IA was registered with the SEC, the IA entered into a contract with the BD calling for the IA to certify annually that it has implemented an AML program that meets the standard of the AML rule that governs broker-dealers, and the IA performs the tasks it was contracted to do.

The old directive's language about the reasonableness of relying on an IA's program was "vague," hence the explicit call for due diligence in the new version , says **Ross Delston**, founder of **GlobalAML.com**, an AML consulting firm based in Washington.

(No-action letter, continued on page 4)

No-action letter *(cont. from pg. 3)*

This means the broker-dealer should look at the IA's AML program as opposed to merely relying on a certification about it, Delston says. See if that program's policies and procedures are comprehensive, check out the qualifications of the AML officer — as a start, ask for that person's resume.

Also ask who at the IA has undergone AML training, and ask when the training occurred, Delston adds.

"If the board of directors, CEO, CIO and CCO have not received training, that's a sign of a weak AML program," Delston says.

Assessing AML risks

Assessing the AML risks of the IA's customer base will be a tougher task because the IA might not want to show you its client files.

If the IA refused to give what you think is enough information, Delston says the IA "should be asked to certify that the customer base does not include any high-risk individuals or groups such as PEPs, that is U.S. or foreign politically exposed persons; individuals resident in or citizens of high-risk countries, such as those on FATF's ICRG list (e.g. Angola, Ecuador, Pakistan, Sao Tome and Principe); high net worth individuals whose source of funds cannot be adequately explained; individuals who are principals or investors in high-risk businesses (arms dealers, precious metals/stones dealers, cash businesses)."

Whereas the old letter said the IA needed to be registered with the SEC, the new one says it must be a *U.S.* investment adviser registered with the SEC.

Contract language

In addition to due diligence, BDs will be required to put a few more details in the contracts they have with IAs regarding CIP.

A new addition is that the contract between the BD and the IA must state that the IA's program must be updated as needed, to implement changes in applicable laws and guidance.

The contract also must require the IA to "promptly" disclose to the BD potentially suspicious or unusual activity that was detected when performing CIP duties on behalf of the BD so that the BD can file a Suspicious Activity Report when appropriate, based on the BD's judgment.

The contract also must say the IA will "promptly" provide its books and records relating to its CIP performance to the Commission, an SRO that has jurisdiction over the BD, or to authorized law enforcement agencies, either directly, or through the BD, when requested by the BD or one of those parties.

Delston speculated that the SEC wants so many details in the contract because there's no regulation that requires IAs to have an AML program.

"You can call this an exercise in contortions and acrobatics because of the simple fact that there is still no requirement for RIAs to adopt an AML program or to file SARs," Delston says. "This is a recognition that at least for the next two years that even though [the **Financial Crimes Enforcement Network**] has not acted [to require an AML program for IAs], more will be expected of RIAs" as a result of these contractual obligations with BDs.

One of the good things about the new letter is that BDs will know exactly what FINRA examiners will expect to see in the contracts if they ask for them, Delston continues.

Clements stressed that you are obligated to verify what the investment adviser is certifying and to test the investment adviser's program.

The no-action letter, he says, doesn't relieve you of any of your supervisory obligations under the various SEC, FINRA, or **NYSE** regulations. The firm "cannot waive their AML, CIP, or any other supervisory responsibilities by having the clients or advisors indemnify the broker-dealer by signing agreements that include hedge clauses or waivers of responsibility and liability," he says. He said firms should have "separate surveillance systems of follow-up and review to monitor, supervise and control flows of client assets managed" by third-party advisers. ■

Note to readers

All *BD Week* articles, dating back to October 1998, are available at **www.BDweek.com**. ■

Customer contact info *(cont. from pg. 1)*

wasn't settled until last fall. Kim was fined $5,000 and suspended for 30 days, ending Nov. 30, 2010.

Since being terminated in 2009, Kim hasn't worked with another member firm at least through to Jan.14, according to his *BrokerCheck* report.

Rules violations

Kim is accused of violating FINRA rule 2010 (standards of commercial honor and principles of trade) and **NASD** rule 3110 (books and records). He was found out by a report that the firm's branch office management received. The report indicated that Kim had made a number of changes to customer contact information through the firm's Client Account Information System, to which Kim had access through his workstation.

The system is the firm's database containing information such as accounts, date of birth, address, telephone numbers and e-mail addresses, according to FINRA.

When confronted about the alterations, Kim said he made them based on instructions from other members of his team. (Kim's settlement document doesn't explain whether actions were taken against those team members, and UBS doesn't comment about individual employees.)

Similarity in cases

In an earlier, similar case, UBS rep **Roslyn Bixby**, who worked in the firm's Newport Beach branch, made inaccurate alterations to the firm's customer contact information because she was leaving UBS to work at another firm, and wanted to "slow down other registered representatives at UBS that she believed would be assigned to call her customers after she resigned," according to a settlement she reached with FINRA last year (*BD Week*, May 24, 2010).

She also was fined $5,000 and suspended for a month. She continues to work at the firm she left UBS for, **Morgan Stanley & Co**.

At the time, a UBS spokesman noted that UBS has a system to alert branch managers of lots of changes to customer contact information – and he stressed that "we keep historical contact info on our books — so it's really a case of a departing [rep] trying to delay the firm from contacting clients, not that we can't contact them at all."

Here is another tip to consider when it comes to reps who are about to leave:

✔ When a rep says he or she is resigning, have the person leave immediately, says **David Sobel**, executive vice president and chief compliance officer of **Abel/Noser Corp**., based in New York. He also notes that you can rely on the backed-up, older versions of your customer contact information if someone tried to insert errors into the current version.

Requiring immediate departure also was mentioned by **Allan Bachman**, education manager of the **Association of Certified Fraud Examiners**. If the person doesn't leave immediately, step up monitoring of that person, and consider placing additional controls on that person's access to systems and their ability to make changes to those systems, he suggests.■

By the numbers

In response to an **SEC** request, **FINRA** last week provided the Commission with a few interesting statistics about broker-dealers. Here they are:

✔ Of the 4,648 firms with an "approved" FINRA status as of Sept. 30, 2010, 53% (or 2,483), had between one and 10 registered individuals. Twenty-nine percent of the firms had between 11 and 50 registered individuals. And almost one out of 10 had 51 to 150 registered individuals.

✔ As of Dec. 31, 2009, the total number of brokerage accounts held by all FINRA-registered firms was 109.5 million retail and institutional accounts.

✔ There were a total of 636,529 registered individuals as of Sept. 30, 2010. This covers any person associated with a firm engaged in the securities business of the firm, including partners, officers, directors, branch managers, department supervisors and salespersons.

✔ A total of 1,734 firms, or approximately 37.3% of the total, had an affiliate engaged in investment advisory activities as of Sept. 30, 2010.■

Congress asked to slow SEC rulemaking, repeal Dodd-Frank

It wasn't long after a hammered gavel sounded in a new Congress that a bill was introduced to repeal the Dodd-Frank regulatory reform law. **Rep. Michele Bachmann** (R-Minn.) submitted H.R. 87 only hours after Republicans assumed control of the House.

While that legislation stands little chance of becoming law, Dodd-Frank opponents may deny the **SEC** the budget it would need to carry out the reform's dictates. "It's the wrong response to deny the agencies" their justified budgets, says **Hal Scott**, professor of international financial systems at **Harvard law school**.

Scott serves on the **Committee on Capital Markets Regulation**, a five-year-old, 32-member board — including top academics. Last month the committee sent a letter to congressional leaders asking Congress to hold hearings into regulators' rulemaking around Dodd-Frank in an effort to slow them down.

Speed "may kill our economy by producing bad rules that interfere with the proper functioning of the financial system for years to come," warns the letter. It notes that Dodd-Frank urges 230 new rules from regulators, including 60 by the SEC by next July alone.

From 2005-2006, the SEC averaged 9.5 rules per year. Dodd-Frank could raise this average to 59 this year, the letter continues.

The average time between proposed and final rules in 2005-2006 was 524 days. After Dodd-Frank, this time will shrink to 208. The average comment period now condenses to about 40 days. It should be at least 60 days to give time for thoughtful industry comment, the committee writes.

"There is a good chance many of these rules will be challenged and overturned, so that the speed of implementation, in the end, is really an illusion," the letter reads. "It's important to get it right. That's more important than to do it quickly," adds Scott. ■

Comment sought on pay-to-play proposed rule for municipal advisors

The **MSRB** is seeking comment on a proposed rule that would regulate "pay-to-play" activities of firms and individuals that advise municipal entities, such as public pension plans and local governments, on municipal securities and municipal financial products.

The rule would also cover third-party marketers that solicit certain business from municipal entities on behalf of others.

Under the proposal, those covered would be prohibited from engaging in municipal advisory business with municipal entities for compensation for two years if they make certain political contributions. ■

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