BDWEEK

Regulatory news and compliance best practices.

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May 14, 2012

Examiners expected to scrutinize underwriters' disclosures to issuers

If you underwrite municipal securities, regulators will expect you to provide the issuer more comprehensive disclosures than you have in the past, thanks to a new **MSRB** Interpretive Notice (MSRB Notice 2012-25) that takes effect Aug. 2.

The notice implements Dodd-Frank's call to protect municipal and state governments from deceptive acts by municipal security dealers (who include underwriters) and by as-yet defined "municipal advisors."

Following up on that general directive, the MSRB last week detailed what should be revealed when disclosing conflicts of interest, such as whether the

(MSRB, continued on page 2)

SRO questions earlier proposal to kill '5 percent policy' on commissions

FINRA is having second thoughts about its plan to eliminate guidance that says 5% is generally too high a commission to charge for equity securities transactions.

A year ago, the regulator proposed eliminating that "5 percent policy" as part of its rule consolidation process for markups, commissions and fees (Regulatory Notice 11-08.) At the time, FINRA said the policy was outdated and from a 1943 study. It stressed that various factors determine what size commission is fair. FINRA said it didn't want to put a specific number in its guidance because it didn't want firms to artificially peg the sizes of their commissions to that number.

But comments submitted about that 2011 proposal caused the regulator to rethink it. Both industry and investor advocates criticized the idea of having no number at all in the guidance.

(Commissions, continued on page 4)

Enforcement Alert

Supervisor fined for inadequate due diligence, allowing unsuitable sales

Make sure your firm has a supervisory system to prevent reps from marketing and selling to non-accredited investors those products specifically designed for accredited investors. Also, your firm needs to conduct proper due diligence on products it's just starting to sell. That due diligence should include monitoring how those products perform even after they've been initially approved by your firm (See related story, page 5).

This message was driven home in a recent settlement in which **FINRA** leveled a $54,000 fine against a formerly registered individual, **Christipher Belonge**, and suspended him from associating with any FINRA firm for six months. Belonge was a supervising principal at Eau Claire, Wis.-based **Pavek Securities, Inc.** from February 2007 through Dec. 15, 2008.

(Life settlements , continued on page 4)

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MSRB *(cont. from pg. 1)*

underwriter bought credit-default swaps against the municipality, and that, unlike a municipal advisor, the underwriter doesn't have a fiduciary duty to the issuer under federal securities laws.

MSRB chairman **Alan Polsky** called the changes "the biggest development in protection of the financial interests of state and local governments since the MSRB was established in 1975."

Bingham partner **Elizabeth Baird** said the notice's requirements could have been enforced under existing rules, noting the regulator's prohibition on unfair practices. "None of these standards are new standards. I think what they're doing is … making it clear that they're going to be looking at this," said Baird, who works in the law firm's Washington office.

Checking for compliance

FINRA or **SEC** examiners, she notes, will be the ones checking out firms' compliance with the notice.

"When FINRA now comes in to examine your underwriting operation, you, underwriter broker-dealer, should have some proof, some place, that you made the right disclosures," Baird said. "To the extent that is new, it's something that will be part of the things that your examiners, whether it's FINRA examiners or SEC examiners, are going to look for in your role as an underwriter – that you made certain disclosures. It would be prudent for broker-dealers to somehow keep evidence of their disclosures so that they can say here's what we warned them of."

Your disclosure also must warn the issuer of risks that can be incurred under the deal.

"It's more of a heads up …. It's probably reacting somewhat to probably a pretty long-term environment where rates have been very low, where creative products appear that provide higher rates, and I think they want to make sure that no matter how sophisticated the issuer is, they get a chance to understand and fully appreciate the risks of a new product. And really, what they're saying is, you, underwriters, are on the hook for making sure they understand it," Baird said.

Meanwhile, the **Bond Dealers of America** (BDA) warned that the MSRB's action could result in differing standards for firms that work with issuers.

"The BDA supports efficient regulation and market transparency and we commend the MSRB for further clarifying obligations owed to issuers. However, we continue to believe that a bifurcated system of regulation exists for the industry absent issuance of a final definition of municipal advisor," said BDA chief executive officer **Mike Nicholas**.

"Without that definition in place, the Commission cannot regulate non-dealer municipal advisors and as a result, leaves open the opportunity for violations of pay-to-play, conflict disclosure and inadequate professional standards — all to the detriment of municipal bond issuers," Nicholas continued. He said the SEC should issue a final and clear definition of municipal advisor "as soon as possible."

Among the requirements in the MSRB's notice,

(MSRB, continued on page 3)

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MSRB *(cont. from pg. 2)*

the underwriter must:

✔ disclose its role, its compensation and any potential material conflicts of interest;

✔ if they recommend complex transactions or products, disclose all material financial risks and characteristics, incentives and conflicts regarding the transactions or products;

✔ have a reasonable basis for the representations made in the preparation of the municipality's disclosure documents; and

✔ pay the municipality a fair price.■

Tips to monitor reps' personal trading include looks at watch lists

To keep tabs on your reps' personal trading, focus on things such as watch lists, holding periods, and possible front-running, suggests **Carol Beckett**, compliance manager at **Wolters Kluwer Financial Services**.

Beckett, who recently crafted suggestions for a code of ethics and personal trading policies for investment advisers, says BDs can benefit from some of those suggestions when it comes to monitoring their reps' personal trading practices. Among them:

✔ **Watch list** — Maintain a watch list of securities that enables you to compare your reps' personal trades, post-trade, with transactions they executed for their clients. Also monitor reps' trades to see if they are making a market. Check out the prices they're getting on their personal trades, and whether they're trading more with one broker than the other. Look for signs of front-running.

✔ **Holding period** — Compare your reps trades with the holding period to see whether they are flipping, and if so, when.

✔ **Monitor gifts and entertainment** — Monitor which brokers your reps are providing gifts to or receiving them from, and check to see whether your rep has accounts with those reps.

Beckett also suggests that to help carry out such policies, firms consider using technology that:

✔ Allows the confirms and statements from reps' personal trading to be compared with the firm's trading;

✔ Enables data regarding personal trading to be integrated with information the firm gets from other data providers;

✔ Accepts electronic broker feeds on employee trades, and is able to track trades according to the list of the rep's brokers; and

✔ Can create comprehensive reporting packages that help spot front-running and other patterns.

Sylvia Scott, a partner in the Los Angeles office of **Freeman, Freeman & Smiley**, said the topic of watch lists is a "hot" one with regulators.

"The **SEC** and **FINRA** brought significant enforcement actions last year based on the broker-dealer's failure to adequately monitor trading in securities on their watch lists, underscoring the point that creating a watch list is just the first step in the compliance process," Scott said.

She noted that in the SEC case, the Commission found that the former compliance "chaperone" didn't take steps to learn about the deals on the watch list. That compliance chaperone was found to be generally unaware of what industry segments the analysts covered.

Also, Scott noted, the firm's policy was that all employees must keep their trading accounts at the firm but the former compliance manager — somewhat different than the chaperone — said that granting permission to keep accounts away from the firm was "too frequent."

The firm settled and paid an $850,000 fine. The violations also included failure to enforce policies and procedures designed to prevent the misuse of material, non-public information.

In the FINRA settlement, which was with a different firm, the regulator found, among other things, that he firm lacked WSPs addressing the creation or distribution of a watch list, Scott noted. The firm was fined $30,000.■

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. ■

Commissions *(cont. from pg. 1)*

So late last month, FINRA's board directed staff to seek comment on a proposal that would keep the 5% language as a guide and "establish a rebuttable presumption that a markup or commission in excess of 5 percent is unfair," FINRA CEO **Richard Ketchum** stated in a letter to firms posted on FINRA's web site .

Last week, in response to an inquiry from *BD Week*, **John Easterling**, CCO and senior vice president of **Frost Brokerage Services** in San Antonio, said he would prefer that such guidance have a specific number in it.

"I don't see how you can do that without a number in it, without *something*. I don't care if they raise it or lower it. We will use and go with whatever FINRA says. It's all plugged into the computer. We do not make a market in anything," Easterling said.

Francois Cooke, a managing director at **ACA Compliance Group**, said, "This is definitely a change from their previous thoughts. I think the industry needs a bright line to work from. It would have been difficult to have given up the 5% guideline."

David Sobel, executive vice president and CCO at **Abel/Noser Corp**., stressed that 5% is just a guideline and there's no clear prohibition for going over that, but that FINRA looks very closely at you and your justifications when you get near that level. As for whether there should be a specific number in the policy, Sobel said, "I've never been upset with the 5% guideline. To me, it's kind of like, if it ain't broke, don't fix it." Competition is driving commissions down, anyway, he said.

The regulator has sanctioned firms for overcharging customers even though the commissions were less than 5%, basing the decision on the specific circumstances in those cases. Although last year's proposal said FINRA didn't want to use a specific number in its policy, the proposal stated that a recent study by an independent consultant found an average markup of 2.2% and a median of 2% for equity transactions.

Board rethinks proposal on commission schedules

Another controversial aspect of last year's proposal that might not see the light of day is a plan to require firms to release their equity commission schedules to retail customers. The board is considering deleting this part.

Wells Fargo Advisers is among those in the industry who weighed in against the idea of requiring firms to give all new customers those schedules and offering it annually to all existing customers, arguing that the cost would outweigh the benefits. It further argued that a provision to require firms to give customers 30 days notice before the commission schedule is changed would be cumbersome. ■

Life settlements *(cont. from pg. 1)*

FINRA said Belonge failed to adequately supervise the sale of a life settlement product to the firm's customers. He also fell short of due diligence responsibilities regarding that product. As a result, reps made unsuitable sales of the product to certain customers, including an 81-year-old woman who wouldn't be able to collect on that investment until she was 87 years old — if the product was legitimate.

But, according to FINRA, the product was a fraud, something that Belonge failed to detect through his due diligence review. Also, FINRA said the product, if legitimate, mainly was for accredited investors, but the 81-year-old woman wasn't such an investor, as was the case with at least three other customers who bought it. In addition, Belonge personally sold the product to two customers for whom the product was unsuitable, resulting in them losing $315,352, FINRA said.

Revisions to the firm's WSPs in January 2008 formally listed Belonge as the principal responsible for rep supervision. Those responsibilities included monitoring and supervising the suitability of reps' sales of the life settlement product. The product, called A&O Capital Appreciation Bonds, was sold through private placements.

Due diligence shortfalls

FINRA said Belonge's due diligence over the bonds was insignificant. The bonds were issued by various affiliates of **A&O Resource Management Ltd.** ("A&O"). The company issued and sold financial products "purportedly collateralized by life insurance policies, and reinsured, or 'bonded,' thus providing the investor with a guaranteed and secure

(Life settlements, continued on page 5)

Life settlements *(cont. from pg. 4)*

return," FINRA said.

Belonge didn't know it, but the principals of A&O misappropriated investor funds, causing investors to lose their entire investments, FINRA said.

Among the inadequacies in Belonge's due diligence review, according to FINRA:

✔ No independent background check performed on one of the three key principals of A&O.

✔ No follow-up review on a background questionnaire that indicated another key principal of A&O had no experience in securities or life settlements. As a result, Belonge failed to discover that the principal was charged with felony forgery in April 2004.

✔ As for the company that "reinsured" the life settlements, **Provident Capital Indemnity, Ltd.**, Belonge "learned and ignored" that around November 2006, the Texas insurance commissioner issued a cease and desist order against Provident. Among the insurance commissioner's findings: that Provident was engaged in the unlicensed sale of insurance and that such conduct was "fraudulent, illegal … [and] creat[ed] an immediate danger to public safety," according to FINRA. Belonge also failed to discover that Provident never was licensed to sell insurance in the U.S.

✔ Belonge "had no understanding" of how A&O obtained the insurance policies that collateralized the bonds.

✔ Belonge never knew or understood why different bond issues had "dramatically different" interest rates, "or why one carried a facially dubious interest rate of 15%."

Carrie Wisniewski, a consultant who is also the president of **Bridge Capital Associates, Inc.**, a small broker-dealer based in Lilburn, Ga., said, "it sounds like this [problem with the issuer and the bonds] was unraveling over a period of time." She suspects that a "cursory Google search" would have identified red flags.

Even after your firm approves the sale of a product, reassess how that product is performing at least annually, Wisniewski recommends. "I don't think [many] small broker-dealers routinely re-vet their products," she says.

Note: Consider investing in a service such as LexisNexis to help vet products and vet principals of companies, Wisniewski recommends. Even though that can be expensive, it's worth it, she says. "A little money on a really good service could go a long way," Wisniewski says, adding that "in a down economy, the crooks really come out in force."

Distinguish accredited from non-accredited investors

Even if the securities weren't allegedly

(Life settlements, continued on page 6)

Supervisory procedures need to explain your due diligence steps

To help ensure proper supervision of private placements, your supervisory procedures must explain in detail how private placement due diligence is conducted, by whom it's conducted, what approvals are needed, and what books and records need to be maintained, says **Michael Clements**, president of **Wall Street Consulting Services LLC**, based outside of Boca Raton, Fla.

Here are a few other things to remember when handling private placements, he notes:

✔ Designate who is responsible for the supervision of private placements with the firm;

✔ Supervisory procedures must designate who will be reviewing and approving accounts;

✔ There should be multilevel checks and balances when approving accounts to ensure suitability and a reasonable basis for recommendations;

✔ All compliance, supervisors and sales personnel must have adequate training at least annually in the sale, marketing and supervision of private placements; and

✔ Private placements must become part of the firm's annual audit program, where the branches, accounts and personnel who are selling and supervising the private placements are scrutinized annually.■

Life settlements *(cont. from pg. 5)*

fraudulent, some were sold to non-accredited investors for whom FINRA says such sales were unsuitable. The regulator said the life settlement product "was intended almost entirely for accredited investors" but Belonge failed to effectively instruct reps about the need to determine whether the investors were accredited.

Belonge "failed to implement any safeguards to ensure that the Firm distinguished accredited from non-accredited investors, resulting in the Firm marketing and selling the A&O product to any customer who expressed an interest," FINRA said.

Suitability

The advanced age of some of the victims clearly made the life settlement product unsuitable for them, Wisniewski said. In addition to the 81-year-old investor, there was a married couple, both 70, who would have received no money for their investment until they were 76 years old.

"Life settlements are something that FINRA's been after for years and years," Wisniewski said.■

Plan advances for narrowing who can be public arbitrators for FINRA

It looks like **FINRA** will narrow the category of individuals who can be a public arbitrator (those individuals who sit on FINRA arbitration panels who aren't supposed to be associated with the securities business).

The FINRA board recently authorized staff to move forward — and seek **SEC** approval — on a proposal to exclude from public arbitrators those persons associated with a mutual fund or hedge fund. Under the current definition, they're not blocked from being a public arbitrator.

Individuals currently excluded from the definition are investment advisers and professionals whose firms get substantial money from financial industry clients, as well as workers, directors or officers of an affiliate in the securities business. People who have spouses or family members in one of those categories also are excluded.

Another change FINRA has proposed is to require individuals who can't be public arbitrators because of industry ties to wait two years after leaving the industry before they can be considered for those slots.■

FinCEN will conduct webinar for compliance pros on filing the new SARs

The Treasury Department's **Financial Crimes Enforcement Network** says it will offer a webinar, probably in mid-June, for financial institution employees and compliance professionals with Bank Secrecy Act-related responsibilities to discuss the BSA E-Filing process for the new Suspicious Activity Reports and Currency Transaction Reports. An exact date hasn't been selected yet.■

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