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FINRA Member Regulation Sales Practice Forum (a/k/a what keeps regulators – and firms – up at night)

A lively and interactive discussion covering regulatory "hot topics" among a panel of regulators and industry representatives marked the most recent meeting of the SRO Sub-Committee of the ABA Securities Litigation Committee on February 25, 2013. FINRA's Susan Axelrod, former head of Member Regulation Sales Practice, recently promoted to EVP of Regulatory Operations, and Michael Rufino, who stepped up from his role as COO of Member Regulation Sales Practice to acting head of that group, joined industry representatives Jeffrey Silverman, Head of Client Litigation at Morgan Stanley, and Douglas Siegel, Head of Compliance at UBS Wealth Management Americas, in a panel moderated by SRO Sub-Committee Co-Chairs, David Boch of Bingham McCutchen, Anne Flannery of Morgan Lewis & Bockius, and Andrew Sidman of Bressler, Amery & Ross. The audience totaled more than 100, in person and via phone.

The conversation opened with a discussion of the soon-to-be-mandatory Risk Control Assessment surveys, covered Rule 4530 self-reporting and closed with concerns and recent enforcement actions involving complex products. Following are highlights of topics covered.

Risk Control Assessment Surveys

Member firms consistently give FINRA feedback that on-site examiners need to be more familiar with that firm's business model before arriving for an examination. From FINRA's standpoint, knowing each firm well, and understanding the risks presented by its particular business, enhances FINRA's ability to conduct risk-based examinations and direct its resources where they are most needed. To that end, in 2012 FINRA issued, for the first time, Risk Control Assessment surveys ("RCAs") to its member firms. According to FINRA guidance, the survey is intended to help FINRA "better understand the business activities that individual member firms engage in, the products and services they sell, and the kinds of clients and counterparties they deal with, and to identify and help us prioritize the underlying risks associated with that business model." *http://www.finra.org/Industry/Regulation/Guidance/RiskControlAssessment/*.

Examiners were required to review a firm's RCA prior to beginning an on-site examination, and FINRA found that this helped them to be more prepared, educated and focused in their reviews. Nevertheless, the FINRA panelists conceded that the 2012 RCAs were long and somewhat cumbersome. Lessons learned from the 2012 experience educated the regulators' work towards reshaping the 2013 RCAs, which were issued in April. FINRA worked to streamline the 2013 RCAs and to add a *de minimis* business exception whereby firms would not have to answer sets of questions that relate to a negligible business line. Moreover, to avoid duplication and excessive burden on firms, FINRA was attempting to marry the RCAs with the Web-IR form, which firms must complete prior to an upcoming exam. FINRA also worked to fix certain technological difficulties that member firms had with the 2012 RCAs.

While this year the RCAs again were voluntary, it is FINRA's expectation that in 2014 they will become mandatory. The panelists encouraged all firms to participate this year, both to educate FINRA with respect to their business models and to provide feedback to further improve the process in anticipation of it becoming mandatory.

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Rule 4530 Self-Reporting of Systemic Problems and Cooperation

Rule 4530(b) which became effective July 1, 2011, requires member firms to self-report violations of "any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization." *See FINRA Rule 4530.*

Though the rule has been in place for over a year, many in the industry still wonder if they are "getting it right" and reporting what FINRA expects them to report at the time FINRA expects them to report it. While the rule requirement is not new for legacy NYSE firms, it is for legacy NASD members. The forum provided an opportunity for the industry members to ask these questions directly of the regulators, sparking an open and candid conversation.

Since the rule came into effect, most of the issues reported to FINRA involve (a) books and records violations, (b) failure to issue confirmations or statements to certain groups of clients or for a certain period of time, (c) email retention violations, (d) operational problems resulting from technology changes and (e) violations of firm internal policies and procedures. FINRA reiterated that it is interested in hearing about systemic issues identified by firms, and is not focusing on one-off problems. With respect to the issue of whether the failure to self-report might itself become the subject of a disciplinary proceeding, FINRA panelists reiterated past guidance that any such proceeding will be based on egregious facts, i.e., "you will know it when you see it." Firms were encouraged to keep an open dialogue with their FINRA coordinators about issues they identify, but were warned that such dialogue does not replace formal reporting when called for. In 2012, there were 127 self-reports by 84 firms, with one to five reports per firm.

Many of the questions from the industry members concerned the timing of required reporting: if a firm reports the systemic problem to FINRA immediately after it is identified, it may not be fully aware of the extent of the issue and most likely will not yet have corrected/remediated the problem. But if a firm identifies and handles the issue internally first, and then reports after the problem has been remediated, will FINRA still give the firm due credit for cooperation?

The FINRA representatives recognized that there is no clear moment that triggers the time to report, but advised members to contact FINRA as soon as the firm determines there has been a systemic failure. While the firm may not have had sufficient time to fully investigate the issue or begin remedial procedures, it should comply with the reporting requirements and be fully transparent. At that point, the firm should make it clear that its personnel are still investigating the problem and have not yet instituted any corrective measures. As investigations continue and the firm takes corrective action, other meetings can follow. FINRA's experience thus far is that some firms are extremely transparent throughout the process, saving FINRA time and effort in its own evaluation, while other firms have been more opaque, leaving regulators uneasy as to how issues are being tackled and addressed.

In line with comments made by Brad Bennett, FINRA's Executive Vice President of Enforcement, at a previous SRO Sub-Committee presentation, FINRA panelists reiterated that the rule is a tool to help identify and address issues rather than an instrument to second-guess a firm's judgment calls regarding what must be self-reported under the rule. Accordingly, if a firm has procedures in place to identify and address systemic issues, and makes a reasoned decision not to report, FINRA is unlikely to second-guess the firm's decision and bring an enforcement action based on the lack of reporting. On the other hand, an enforcement action may follow where a firm recognizes a violation and intentionally chooses not to self-report or where a firm does not have or does not follow reasonable procedures designed to identify issues reportable under Rule 4530(b). To date, no such actions have been brought. Independent enforcement actions, based on the underlying systemic failure, may or may not follow the self-reporting.

Although credit for extraordinary cooperation continues to be available, a firm does not earn such cooperation credit by simply self-reporting, which is expected of member-firms and required pursuant to Rule 4530(b). Self-reporting is the "baseline" and not "extraordinary." A firm seeking to earn cooperation credit should work with FINRA following the reporting by being transparent, forthcoming with information, and proactive about corrective action.

Servicing Vulnerable Investors

The protection of senior investors and other potentially vulnerable clients continues to be a focus for regulators as well as the industry. From a regulatory standpoint, the employment by FAs of titles and designations (e.g. "senior specialist") that are not accompanied by appropriate accreditation continues to be a concern. FAs hosting lunches for seniors and/or gaining access to retirement communities also raises red flags. While age alone does not affect clients' rights to manage their assets and discuss investments with FAs, there must be a higher scrutiny of these interactions to prevent abuse of potentially vulnerable clients.

Dealing with a vulnerable client is challenging in many ways, and training FAs in how to best work with them is paramount in preventing problems. A robust training program must address recognizing the signs of a vulnerable client, which go beyond age, and can include a young person with a disability, someone who has just received a settlement or sum they will rely on for living expenses, or someone developing early signs of dementia. Industry panelists remarked that advanced age, alone, does not necessarily make someone vulnerable, and investors of advanced age who fully understand their portfolio allocation and investment decisions may resent being second-guessed. Tailored suitability training for FAs is also vital, specifically with respect to liquidity, risk and investment time-horizon. On top of training, some firms choose to block the sale of certain investments to clients that have reached a certain age group. *FINRA's September 2007 Regulatory Notice 07-43* is an extremely useful resource in navigating this difficult issue.

Mental health issues, such as dementia, present particularly difficult challenges. Training can help FAs identify early signs of the problem – e.g. when a client forgets a recent conversation, or transaction – and can teach them when to escalate concerns to a branch manager. Consulting family members when a client's mental health becomes a concern may seem appropriate, but also has its own pitfalls, such as running afoul of privacy concerns and Regulation S-P. The issue presents

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a fine line for the industry to walk and FINRA agreed that it may be appropriate for regulators to look more closely at this issue and how to reconcile Regulation S-P with the need to reach out to a client's next of kin.

Cyber Security

Cyber security and hacking is at the top of the list of things keeping FINRA and its members up at night. All agree on the severity of the potential impact of cyber threats and are challenged by the ever-changing technologies used to infiltrate financial market systems. Concerns range from hackers causing work stoppages and market disruption, to accessing and misappropriating clients' confidential information, and gaining access to firm systems to drain funds. FINRA described the issue as a national industry issue rather than a competitive issue.

Larger member firms are engaged in a partnership with the government to combat hacking and improve cyber security, and have the personnel and resources to implement defensive technologies. Smaller firms, on the other hand, are especially concerning to FINRA, as exams have shown particular vulnerability in technology systems, with problems like expired or ineffective anti-viral software. Moreover, if an attack is successful, the financial constraints of a small firm may be significant and impair their ability to compensate the victims.

The industry panelists discussed the fact that no matter how excellent the defensive technology and robust the controls, theft may occur, but such events do not necessarily mean there has been a systemic failure worthy of discipline. FINRA suggested one way to help combat the problem is having FAs and supervisors become more comfortable with and vigilant about calling clients to confirm orders. While clients once may have been annoyed by such calls, many have come to appreciate these as safeguards taken for their own benefit.

Complex Products And Investor Education

The panel concluded with a dynamic discussion about the complex and oft-changing financial products available to investors in today's market, particularly in the current low interest rate environment in which clients seek higher yields. "Complex" products, including, for example, non-exchange traded real estate investment trusts ("REITs"), steepeners, reverse convertibles, and exchange traded notes, remain concerns for both FINRA's Member Regulation and Enforcement.

For example, in September 2012, FINRA announced the issuance of targeted examination letters, or "sweep" letters, to various firms seeking "Non-Traded REIT Communications." *See Targeted Examination Letters Re: Spot-Check of Non-Traded REIT Communications.* Through the sweep, FINRA sought to review advertisements and other communications directed at customers with the goal of ensuring that customers are being provided with appropriate, balanced information. In line with this sweep, Enforcement is currently working on an initiative to review sales of non-exchange traded REITs. On the heels of the sweep, in October 2012, FINRA announced its $14 million settlement with David Lerner Associates concerning its marketing and sale of a non-traded REIT and for charging excessive markups on municipal bonds and CMOs. *See http://www.finra.org/Newsroom/NewsReleases/2012/P191729.*[1]

[1] FINRA reported that "DLA solicited thousands of customers, targeting unsophisticated investors and the elderly, selling the illiquid REIT without performing adequate due diligence to determine whether it was suitable for investors" and "used misleading marketing materials that presented performance results for the closed Apple REITs without disclosing to customers that income from those REITs was insufficient to support the distributions to unit owners."

FINRA is also seeking to do its part and educate the public with respect to certain investment products, including through Investor Alerts. A recent issue titled "*Duration -- What an Interest Rate Hike Could Do to Your Bond Portfolio*" resulted from concerns arising from the current interest rate environment. Through its release, FINRA sought to "help investors understand the importance of duration risk" as related to investments in bond funds. FINRA Investor Alerts can be found at *http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/*.

The reality is that complex products are not going away – there is and will continue to be investor appetite for alternative products and the industry is as creative as ever in putting them together. In response, firms need to be diligent and thorough in getting to know the products and deciding how to market and sell them. FINRA will continue to want to see what a firm has done regarding vetting and selling complex products, including what its policies and procedures say about the process. Particular focus continues to lie on FA education and training with respect to the products, disclosures to customers and suitability. The fact that a particular product is traded on an exchange does not alleviate a firm's responsibility to perform its due diligence and suitability analysis. ■

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

Andrew W. Sidman, Esq.
asidman@bressler.com
212.510.6916

Diana C. Campbell Miller, Esq.
dcampbell@bressler.com
212.510.3984

Christina R. LoConte, Esq.
cloconte@bressler.com
212.510.6903

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