



Morgan Lewis

Compliance Roundtable Seminar

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Table of Contents

- Introduction
- Regulatory Examinations and Enforcement
- Regulatory Reform
- Recent Rule Proposals and FINRA Guidance
- Trade Reporting Challenges and Practices

Regulatory Exams & Enforcement - SEC

- New Leadership
 - Robert Khuzami, Director, Division of Enforcement
 - Carlo di Florio, Director, Office of Compliance Inspections and Examinations
- Internal Reform of Enforcement Division
 - Management restructuring
 - Specialized units
 - Asset Management
 - Market Abuse
 - Structured and New Products
 - Foreign Corrupt Practices
 - Municipal Securities and Public Pensions
 - Office of Market Intelligence
 - Office of Managing Executive

Regulatory Exams & Enforcement - SEC

- Key SEC Initiatives (Securities Fraud)
 - OCIE – Sweep of collateral pool managers (CDOs and other structured products)
 - Market Abuse – Pattern and relational trading analysis; focus on identifying misuse of MNPI and abusive trading practices by analyzing trading strategies across all types of securities
 - Asset Management – Disclosure and valuation for mutual fund bond portfolios; Problem Adviser Initiative; Mutual Fund Fee Initiative
 - Municipal Securities and Public Pensions – Municipal advisers; MOU with IRS regarding tax-exempt bonds
 - Structured and New Products – Review of various complex securities products (e.g., reverse convertible notes, principal protected notes, total return swaps)
 - Foreign Corrupt Practices – Cooperation with law enforcement to pursue significant cases involving bribery and corruption by U.S. companies and corporate executives in their international operations

Regulatory Exams & Enforcement - SEC

- Dodd-Frank Act
 - Whistleblower program
 - Nationwide service of process
 - Secondary actors - aiding and abetting liability
 - Remedies
 - Civil penalties in cease-and-desist proceedings
 - Collateral bars
 - Extension of statute of limitations for the prosecution of a “securities fraud offense” from five to six years
 - Repeal of FOIA exemptions

Regulatory Exams & Enforcement - FINRA

- New Leadership
 - Susan Axelrod, Member Regulation Sales
 - Jim Shorris, Acting Director of Enforcement
- Targeted examination letters
- Process Improvements
 - Consistent staffing model (investigators and lawyers working together on teams)
 - Task forces (Reg. D offerings, municipal securities transactions, day trading)
 - On-site enforcement investigations

Regulatory Exams & Enforcement - FINRA

- Market Surveillance and Enforcement
 - Effective June 10, 2010, FINRA assumed responsibility for performing functions previously conducted by NYSE Regulation
- Office of the Whistleblower
 - High-risk tips
- Office of Fraud Detection and Market Intelligence
 - Fraud detection and investigation

Regulatory Exams & Enforcement - FINRA

- FINRA Priorities
 - Non-Investment Company Exchange Traded Products Communications
 - New products review process
 - Regulation D offerings and suitability
 - E-mail management and reviews
 - Complex products
 - Outside business activities

Regulatory Exams & Enforcement - FINRA

- Non-investment company exchange traded products
 - Covered review of advertisements, sales literature and institutional sales materials for
 - ETFs that are not registered as investment companies
 - ETNs
 - Spot-check review conducted by Advertising Regulation Department
 - Materials used from November 1, 2009 to May 31, 2010
 - Focused on evidence of principal review, offering documents and written supervisory procedures

Regulatory Exams and Enforcement - FINRA

- New products review process
 - Written procedures for new product review
 - Process for identification of new products or services
 - Document process - standard questionnaire
 - Initial “multi disciplined” review - business unit, compliance, legal, operations, sales, training
 - Formal “new product” approval
 - Limitations, qualifications, requirements for sale
 - Training requirements
 - Operational and supervisory requirements
 - Post approval review
 - Versus sales forecasts
 - Unanticipated risks
 - Product performance vs. expectation

Regulatory Exams & Enforcement - FINRA

- Regulation D Offerings and Suitability
 - FINRA initiative
 - Broker-dealers involved in retail sales of private placement interests
 - Broker-dealers affiliated with private placement issuers
 - Compliance with suitability, supervision and advertising rules
 - Potential instances of fraud
 - Reasonable basis suitability obligations (Regulatory Notice 10-22)

Regulatory Exams & Enforcement - FINRA

- Email Management and Reviews
 - Process for reviewing (sampling) electronic communications
 - Retention of electronic communications
 - Management of new and evolving technology
 - Privileged communications

Regulatory Exams & Enforcement - FINRA

- Complex Products
 - Reverse Convertibles - Regulatory Notice 10-09
 - Principal Protected Notes - Regulatory Notice 09-73
 - Non-Traditional ETFs (Leveraged and Inverse ETFs) – Regulatory Notice 09-31
 - Variable Contracts – Regulatory Notice 10-05
 - Equity-Indexed Annuities – Regulatory Notice 05-50
 - Non-Conventional Investments (Asset Backed Securities, Distressed Debt, and Derivative Products) – Notice to Members 03-71

Regulatory Exams & Enforcement - FINRA

- Outside Business Activities
 - Enterprise Control Room
 - Watch list
 - Restricted list
 - Pre-clearance
 - Section 16 insiders
 - Access persons
 - Dual-registrants
 - Conflicts of interest
 - Affiliate transactions

Regulatory Reform

- Resulted in need for regulators to create 243 rules, conduct 67 studies and issue 22 periodic reports
- Created 3 new agencies and other additional offices of existing regulators
- 16 Provisions/Titles that address many areas from private fund regulation to ABS securitization to reporting on mine safety
- Key outcomes include:
 - Fiduciary standard
 - Broker-dealer disclosure and point of sale
 - Accredited investor definition change
 - Registration of “municipal advisors”



Regulatory Reform

- Study on fiduciary standard to be completed in 6 months
- Broker-dealer disclosure and “point of sale”
 - Applicable when retail investors purchase products and services
 - Disclosure on costs, risks and conflicts of interest
 - Previous attempts failed
- Accredited investor definition change
- Municipal advisors
 - Registration effective October 1, 2010

Recent FINRA Guidance

- Regulatory Notices
 - Notice 10-06 Social Networking
 - Notice 10-25 Registration Category for Operations Supervisors
 - Notice 09-69 Payments to Unregistered Persons
- Rule Proposals
 - SR-FINRA 2010-21 Encryption of Information
 - SR-FINRA 2010-039 KYC and Suitability
 - SR-FINRA 2010-042 Verification of Assets Held at a Financial Institution
 - SR-FINRA 2010-043 Short Exempt Marking for Trade Reporting and OATS

Recent FINRA Guidance

- Social Networking
 - Responsibility of Supervision – Clear designation by the broker-dealer is needed to determine whether communications are suitable and that adequate records are maintained. Appropriate procedures must also be written.
 - Suitability – FINRA suggested that a good practice would be to prohibit providing recommendations unless prior approval is received by a principal. Another alternative is for the broker-dealers representative to use pre-approved templates or to ensure that the communication conforms to the pre-approved template.
 - Interactive Electronic Communications – Websites that have both static and real time communications such as on Twitter, LinkedIn and Facebook, the real time communication must be supervised as an interactive electronic forum. The static portion would be considered advertising.
 - Efforts of Technology Providers – FINRA highlighted the challenge to maintain records of social networking sites and the efforts by technology providers to offer solutions to monitor and maintain records of employee activities.

Recent FINRA Guidance

- Two options:
 - Block access through firm network and prohibit use for business purposes
 - Allow use and implement appropriate controls:
 - Firm approved list of social networking sites
 - Principal approval of each posting
 - Ongoing review & approval
 - Retention of each posting for three years from date of last use
 - Clear identification of broker-dealer and/or investment adviser
 - FINRA filings as applicable
 - Difficult to supervise and maintain appropriate books & records
 - Consider investment adviser regulatory issues for dual registrants

Recent FINRA Guidance

- Registration Category for Operations Supervisors
 - Persons required to register:
 - Senior management over “control functions”
 - Supervisors, managers and other persons who approve or authorize “work in direct furtherance of the covered functions”
 - Persons who have authority or discretion to commit the firm’s capital or to commit the firm to any contract “in direct furtherance of the covered functions”

Recent FINRA Guidance

- Payments to Unregistered Persons
 - Prohibits members or associated persons from, directly or indirectly, paying or offering to pay compensation, fees, concessions, discounts, commissions and other allowances to:
 - any person not registered as a broker under Section 15(A)
 - Any appropriately registered associated person, unless in compliance with applicable law
 - Continuing commissions to retiring representatives
 - Foreign finders?

Trade Reporting

- Trading Issues
 - General
 - Best execution
 - Mark-up/down
 - Fixed Income
 - TRACE and MSRB reporting
 - Equities
 - Order Audit Trail System (“OATS”) reporting
 - Regulation SHO issues
 - Risk Management

Trade Reporting

Trade Risk Management

The SEC has proposed Rule 15c3-5 that would require brokers with market access, including those who sponsor customers' access to an exchange, to put in place risk management controls and supervisory procedures. The procedures are intended to help prevent erroneous orders, ensure compliance with regulatory requirements, and enforce pre-set credit or capital thresholds.

- A system-driven, pre-trade control reasonably designed to reject orders that are not reasonably related to the quoted price of the security
- Systematically limit the financial exposure of the broker or dealer that could arise as a result of market access

Trade Reporting

- Systems that would block orders that do not comply with exchange trading rules relating to special order types and odd-lot orders, Regulation SHO and Regulation NMS, and applicable margin requirements
- Establish credit thresholds for each customer based on appropriate due diligence as to the customer's business, financial condition, trading patterns, and other matters, and document the decisions
- Aggregate an exposure threshold for each account or by sector or security
- Reject the entry of orders that exceed the applicable credit or capital thresholds
- Limit the use of electronic order entry systems to authorized persons
- Validate order accuracy and prevent the unwanted generation, cancellation, re-pricing, re-sizing, duplication, or re-transmission of orders

Questions?

