



Morgan Lewis



Compliance Roundtable Seminar

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Broker-Dealer Session



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SEC Open Letter

- “Dear Chief Executive Officer” Letter from SEC Chairman Schapiro on August 31, 2009
- Reminder to firms and their CEOs of supervisory responsibilities with respect to sales practices; and the potential impact of enhanced compensation practices
- Encouraging firms and their CEOs to:
 - Closely monitor sales practices; and
 - Ensure that firm’s supervisory and compliance infrastructure keeps pace with expansion of sales force

Universal Fiduciary Standard

Finding, Redefining and Refining the Fiduciary

“Historically, broker-dealers that simply effected transactions as directed by their clients generally would not be fiduciaries and had duties focusing on the transaction service they provided. As broker-dealers increasingly provide advice to their clients, the higher standards and fiduciary duties of advisers should also be applied to these broker-dealers.”

- SEC Commissioner Luis Aquilar - January 10, 2009 speech to the North American Securities Administrators Association



Universal Fiduciary Standard

Finding, Redefining and Refining the Fiduciary

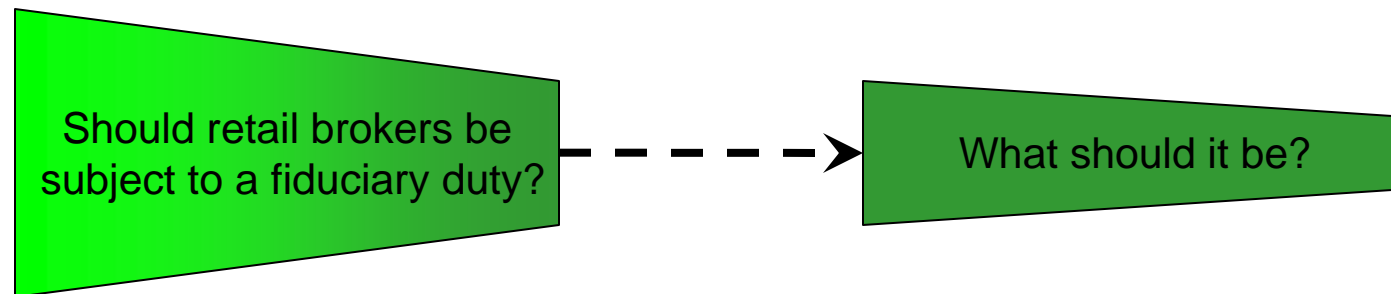
“Rather than perpetuating an obsolete regulatory regime, SIFMA recommends the adoption of a ‘universal standard of care’ that avoids the use of labels that tend to confuse the investing public, and expresses, in plain English, the fundamental principles of fair dealing that individual investors can expect from all of their financial services providers.”

- SIFMA President Timothy Ryan, Jr. - March 10, 2009 testimony before the Senate Banking Committee



Universal Fiduciary Standard

The debate has narrowed:



Universal Fiduciary Standard

A fiduciary duty has two parts:

- *Duty of Loyalty* = Duty to put your clients' interests before your own and to disclose all conflicts of interest.
- *Duty of Care* = Duty to devote reasonable care and diligence to handling your clients' business.
- The current debate is primarily about the *Duty of Loyalty*.



Universal Fiduciary Standard

“What a fiduciary duty requires depends on the scope of the engagement. Thus, it will mean one thing for a mere order taker, another thing for someone who provides a one-time financial plan, and yet something else for someone who exercises ongoing investment discretion over an account. What a fiduciary duty requires may also depend, in certain respects, on the sophistication of the investor. What may be appropriate behavior toward large institutional investors, with knowledgeable counsel, may not be appropriate behavior toward retail investors like Aunt Millie who are not always going to understand the meaning of disclosures regarding certain conflicts of interest.”

- SEC Commissioner Elisse Walter – May 5, 2009 speech to the Mutual Fund Directors Forum



Outside Activities

- Proposed FINRA 3230 (NASD 3030/NYSE 346)
- Related Topics
 - Selling Away – FINRA 3110 (NASD 3040)
 - Conflicts of Interest 3050 (exempt from 3270?)
- Recent enforcement actions
 - Technology goes both ways (see next slide!)
Regulators are trolling these sites for information

Social Networking Issues

Social Networking Sites are on-line communities, which can be social and/or professional in nature.

- Examples are: LinkedIn, Facebook, and Twitter
- If on-line profile includes business related information, SEC and FINRA rules apply
- Social Networking sites can fall into more than one category - Advertising, Sales Literature, Correspondence, Public Appearances
- If access is **restricted** to contacts, business communications would be considered Sales Literature
- If access is **public** and has no restrictions, business communications would be considered Advertising

Rules that apply:

- Approval and Recordkeeping (Rule 2210(b))
- Supervision (Rule 3010)
- Books & Records (Rule 3110)
- Conflicts of Interest (Rule 2711, IM-2210-1, etc.)

Social Networking Issues (continued)

- Firms have two options:
 1. **Block access** through the firm network and prohibit use for business purposes
 2. **Allow use** and implement appropriate controls, to include but not limited to:
 - Maintain a list of Firm approved social networking sites
 - Procedure for written principal approval of each posting
 - Procedure for on-going review & written approval
 - Retention of each posting for at least three years from date of last use
 - Must clearly identify broker-dealer and/or investment adviser
 - Certain postings (such as those referencing mutual funds, variable annuities) must be filed with FINRA
- Difficult to **supervise** and maintain appropriate **books & records**
- Must consider investment adviser regulatory issues for dual registrants

Vendor Management

a.k.a. “Outsourcing”

Guidance by **Notice to Members 05-48** indicating that an appropriately qualified person monitor the arrangement with third party service providers as part of the supervisory structure.

- **Accountability** and supervisory responsibility for outsourced functions
- Activities and functions that are **prohibited** from being outsourced
 - Activities and Functions Requiring Registration and Qualification
 - Supervisory and Compliance Activities



Vendor Management (continued)

The following are possible leading practices to consider:

- The **experience and ability** of the service provider to perform the services in question
- If the service provider **sub-contracts** services, the ability of any sub-vendor to perform services material to the performance of the outsourcing contract
- The service provider's **reputation and financial status**
- Whether appropriate **internal controls** related to the specific services provided are maintained by the service provider
- Whether the service provider's **business continuity plan** enables the firm to comply with rule requirements it is subject to
- The extent of **insurance coverage** maintained by the service provider with respect to losses that may occur from the service provider's performance
- The effectiveness of the service provider's **privacy and confidentiality controls**
- **Access** by applicable regulators to the information produced under the contract which is deemed to be the property of the firm for regulatory purposes; and
- The ability to maintain an **adequate level of service** over time and to assess the risk of over-concentrating functions with any one service provider

New Products

- **Written procedures** for new product review
- Process for **identification of new product or services**
- **Initial product review** and include all areas of company
 - Business unit
 - Compliance
 - Legal
 - Operations
 - Sales
 - Training
 - Document process
 - Use of standard questionnaire
- **Formal approval**
 - Senior management or committee



Areas Of Increased Regulatory Scrutiny

- LIETFs
 - FINRA NTM 09-31; SEC/FINRA Joint Investor Alert; FINRA Podcasts
 - Addresses suitability issues for typical buy/hold retail investors
 - Education & disclosure is critical
- Alternative Investments
 - Increasing demand as markets recover
 - Focus on understanding the security and providing customer-specific suitability analyses
- Cash Alternatives
 - “As safe as cash” or “cash equivalent” – will surely draw a searching eye from regulators
 - Again, a focus on understanding the security and providing customer-specific suitability analyses



A Cash Equivalent?

Other Areas Ripe for Enforcement



– Anti-Money Laundering

- Firms must focus broadly on suspicious activities related to securities transactions rather than solely on money movements
- “One size fits all” approach will **NOT** suffice
- FINRA E*Trade Action (Jan. 2009)

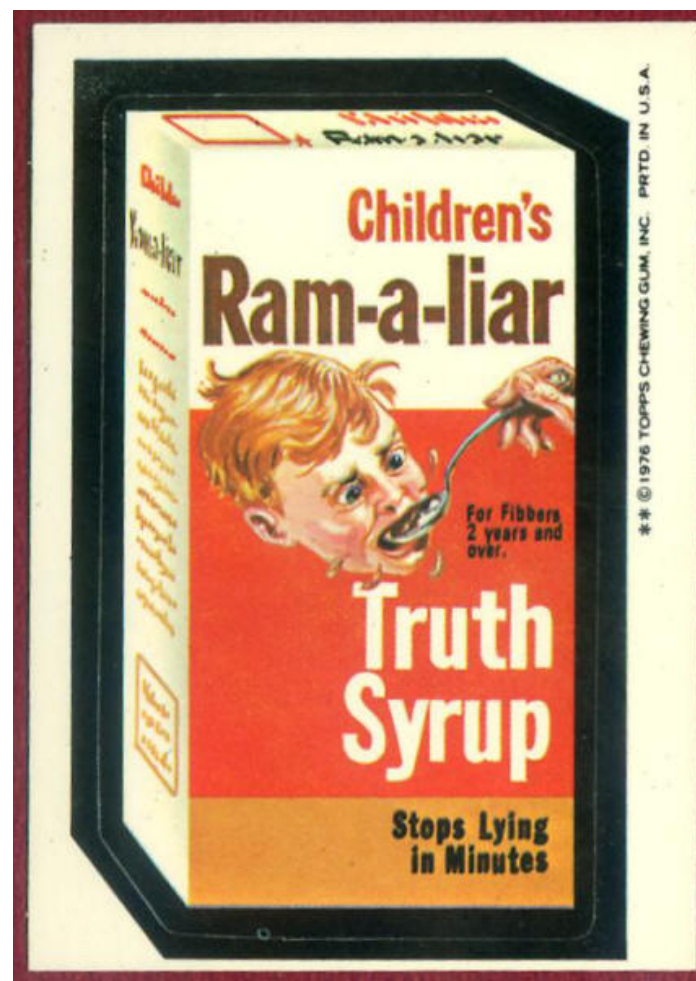
– FCPA

- FINRA has recently reminded members that they are obliged to comply with FCPA
- SEC has been pursuing FCPA cases vigorously
- FCPA “Red Flags”

Other Areas Ripe for Enforcement

– Rumors

- Under FINRA Rule 6140(e), registered persons are prohibited from making statements or circulating or disseminating any information that might reasonably be expected to influence the market price of certain securities
- Proposed Rule 2130 – affirmative duty to report rumors
- SEC Working Group
- Investigations/Prosecutions



Questions?

