

Morgan Lewis

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First Clearing Correspondent Services –
Compliance Roundtable

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Current Topics for Investment Advisers

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Discussion Topics

- Update on Nondiscretionary IA programs
- Independent RIA issues
- Current Regulatory Initiatives
 - Privacy
 - Form ADV Part 2
 - National exam letter

Update on Nondiscretionary IA programs

- Accounts transitioned in October 2007
- Temporary Rule 206(3)-3T: limited principal trade relief; expires 12/31/09 unless SEC acts
- Proposed Rule 202(a)(11)-1
 - Account by account status
 - Commission differentials
 - Limited/temporary discretion ok

Update on Nondiscretionary IA programs

- Rand Study released
- Financial planning reverts back to pre-rule analysis – fee or free?
- SEC exams of NDA accounts
 - How were accounts transitioned – negative consent, Form ADV delivered, securities sold out of fee-based brokerage accounts, fees incurred in connection with the transition?
 - Compliance with principal trade rule
 - Evidence of investment advice provided
 - Rep training

Independent RIA issues

- Reps of broker-dealers establish independent investment advisers
- Creates compliance and supervisory issues for the broker-dealer under FINRA Rule 3040
 - Prior approval
 - “Selling compensation” includes advisory fees
 - “Participation” in the execution of securities transactions – more than a mere recommendation
 - Supervisory obligations

Independent RIA Issues

- **Impact of Proposed Rule 3110(b)(3)**
 - Applies to “any outside investment banking or securities business” – not just securities transactions
 - If approved, independent RIA activity is considered “within the scope of the member firm’s business”
 - Subject to the full panoply of supervisory obligations

Privacy Update

- Regulation S-P requires firms to safeguard and dispose of customer information
- The safeguard rule requires firms to:
 - Adopt written policies and procedures for administrative, technical and physical safeguards to protect customer records and information
 - Provide customers with notice of the firms' privacy policy and the opportunity to opt out from having their information shared with nonaffiliated third parties
- The disposal rule requires firms to properly dispose of consumer information
- Recent SEC enforcement action involving *NEXT Financial* has focused attention on releases of customer information when representatives shift firms
- Risks of data breaches continue to threaten companies, employees and consumers – *LPL Financial Corporation*

Privacy Update

- On March 4, 2008, the SEC proposed changes to Regulation S-P that, if adopted, will
 - Require firms to implement a comprehensive ***information security program*** above and beyond the requirements of the current safeguard rule
 - Implement new security breach response requirements
 - Expand the scope of the current safeguard and disposal rules
 - Create a new exception from the notice and opt out requirements for the limited disclosure of personal information where a representative moves from one firm to another

Privacy Update

- Proposed changes would extend the disposal rule to specifically apply to “covered persons” (associated persons and supervised persons)
- Carve out from customer notice and opt out requirements disclosure of certain information when a covered person moves between firms
 - Allows firms to share limited customer information with the rep’s new firm
 - Permitted Information
 - Customer’s name
 - General description of the account type and products held by the customer
 - Contact information, including address, telephone number and e-mail address
 - Excluded Information
 - Customer’s account number, social security number or securities positions
 - Firms relying on this exception must obtain and maintain a written request from the departing person for *the information that would be disclosed*

Update on Form ADV Part 2

- Timing
- Delivery versus offer
- New Items
 - Item 2 – Summary of Material Changes
 - Item 6 – Performance Fees and Side-By-Side Management
 - Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss
 - Item 16 – Investment Discretion
 - Item 17 – Voting Client Securities
 - Item 18 – Financial Information
 - Appendix 1 to Part 2A – The Wrap Fee Program Brochure
 - Part 2B – The Brochure Supplement

Update on Form ADV Part 2

- Enhanced disclosure about other types of fees and expenses clients may pay and the receipt of compensation for the sale of securities or other investment products
- Performance fees & side by side management – Disclosure, conflicts & how addressed
- Enhanced disclosure about risks of particular strategies and securities
- Enhanced disclosure of conflicts related to "Financial Industry Affiliations"
- Enhanced disclosure of conflicts involving soft dollars and directed brokerage

Update on National Exam Letter

- 27 page NYRO letter released fall of 2007
- Advisers objected to several questions (“bad thoughts,” rumor policies, certain investors in hedge funds)
- Letter asks for more documents and more detail – moving away from risk-based approach?
- Revised letter not yet released, but intended to take a layered approach (supplemental requests)

Appendix

- Interpretive Rule Under the Advisers Act Affecting Broker-Dealers – IA-2652 (Sept. 24, 2007) available at <http://www.sec.gov/rules/proposed/2007/ia-2652.pdf>
- Privacy – IA-2712 (March 4, 2008) available at <http://www.sec.gov/rules/proposed/2008/34-57427.pdf>
- Form ADV – IA-2711 (March 3, 2008) available at <http://www.sec.gov/rules/proposed/2008/ia-2711.pdf>