

Morgan Lewis

C O U N S E L O R S A T L A W

Bank Affiliated Brokers - The Year Ahead

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The Year Ahead

- Continued Focus on Conflicts
 - Conflicts in Fund Sales
- Supervisory Controls
 - NASD Supervisory Controls
 - CCO Certification
 - Branch Office Definition
 - SEC Record Keeping Exams
- GLBA Implementation
- Other Likely Developments

Continued Focus on Conflicts

- Regulators will continue to focus on conflicts generally
 - SEC Enforcement Director Steve Cutler:
 - Just because a certain way of doing things is second nature to you, and appears to be standard operating procedure on the Street, doesn't mean it's the correct way of doing things
 - When your customers finally do come to understand certain industry practices, they will care a great deal about undisclosed conflicts of interest
 - Class action plaintiff lawyers will follow suit

Conflicts in Fund Sales

- NASD will continue to scrutinize conflicts
 - Breakpoint & related refund issues
 - Sales contests
 - Late trading/market timing
 - Shelf space disclosure
 - Brokerage for fund sales
- NASD will adopt amendments to Rule 2830
- SEC will tighten 10b-10 disclosure of third party remuneration
- SEC will address brokerage-for-fund sale issues
- Funds will increasingly seek assurances in these areas and will amend dealer agreements

NASD will amend Rule 2830

- Requires that members disclose revenue sharing arrangements and differential cash compensation arrangements
 - Disclose where to find info on fund fees & expenses and brokerage practices
 - Disclose if the firm receives cash payments (other than sales charges & service fees disclosed in the prospectus)
 - And list the offerors that made the payments in descending order based on compensation received

NASD will amend Rule 2830

- Disclose if an associated person receives different rates of compensation based on which funds are purchased, the nature of the arrangements, and the names of funds favored
- Give this information to customers:
 - At account opening or, if no account is established, when the customer first purchases funds
 - For current customers, later of 90 days or on next fund purchase
 - Semi-annually, by posting on website or by mailing hard copy

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Supervisory Controls

- NASD will adopt supervisory control amendments
- NASD will adopt CCO certification rule
- NASD will adopt proposed amendments to the definition of “branch office”
- SEC will begin record keeping exams

NASD Supervisory Controls

- Office inspections
 - Inspections to be done by persons other than the BOM or another supervisor in the office (or subordinate)
 - Heightened procedures required if inspector reports to BOM's supervisor & BOM generates 20% of supervisor's income
 - Inspections must test & verify procedures concerning:
 - Safeguarding customer funds and securities
 - Keeping records
 - Supervising accounts serviced by BOMs
 - Moving funds between customers, RRs & others
 - Validating changes to customer address & account info

NASD Supervisory Controls

- Supervisory controls
 - Designation of principals responsible for testing & verification of procedures
 - Annual management report with test summary & significant exceptions
 - Procedures to review and supervise producing managers by “senior” person
 - Controls for certain customer account activity
- Other
 - Time and price discretion good for a day
 - Approvals for changes to accounts listed on order tickets

CEO/CCO Certification

- Require each member to designate a CCO
- CCO and CEO to certify annually that the member has in place adequate compliance and supervisory policies and procedures
 - CEO and COO's obligation is "limited" to executing the certification on a reasonable basis that comports with the high standards of commercial honor and just and equitable principles of trade
 - According to the NASD, neither CEO or COO would incur greater liability than would otherwise be the case absent certification

Branch Office Definition

- Any location where associated persons regularly conduct the business of effecting transactions in, or inducing or attempting to induce the purchase or sale of, any security, or that is held out as such
- Exclusions
 - Location established only for customer service or back office tasks where no sales activities are conducted and that is not held out to the public
 - Office of convenience where associated persons occasionally and exclusively by appointment meet with customers, which is not held out to the public (excluding required networking signage)
 - Location used primarily to engage in non-securities activities and from which associated person effects no more than 25 securities trades in any calendar year if any ad or sales literature identifying the location also sets forth the address and telephone number of the location from which the associated persons are directly supervised

SEC Record Keeping Exams

- Three Types of Rule Amendments
 - Sales Practices
 - Local Office
 - Federalize SRO Rules
- Three Main Areas of Change
 - Customer Account Information & Suitability
 - Records re: Associated Persons
 - Records to be kept at Local Offices
- Changes went effective May 2, 2003
- Email too!

GLBA Implementation

- Dealer exceptions - Rules effective 10/1
- Broker exceptions - Rules deferred until 11/04
- Retail Bank broker-dealer issues
 - Networking arrangements
 - Service company arrangements - OTS letter
 - Finders fee issues
 - NASD Rule 3040 issues with joint employees

Other Likely Developments

- NASD will adopt “investment analysis tools” interpretation
- NASD will bring more enforcement cases for hedge fund advertising abuses
- Ongoing developments regarding
 - AML
 - Variable annuities sales practices
 - Do not call, email or fax issues

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Hot Topics and the Year Ahead

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