BD WEEK

Regulatory news and compliance best practices.

INSIDE...

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Enforcement Alert
Detail how you will guard against excessive commissions, case shows

Make sure your WSPs spell out how frequently your supervisors check the firm's commission charges for muni transactions. Failing to do that was one of the factors that resulted in **FINRA** slapping a New York firm with a $10,000 fine.

FINRA fined **Kimelman & Baird, LLC** $5,000 because the firm was collecting excessive agency commissions for muni transactions and another $5,000 for having inadequate WSPs, according to the letter of Acceptance, Waiver and Consent (AWC) signed by the firm.

The message here: Put in writing the process your firm will use to determine commissions, stick to those procedures, and train supervisors and reps in them, says **David Thetford**, a securities compliance principal analyst at **Wolters Kluwer Financial Services**, a consulting firm based in Minneapolis.

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Inside the FINRA Exam: AML, trade execution are strong focus areas

Here's a good way to get your **FINRA** examiners to leave early: Organize and label everything on their lists before they arrive.

That's what **Planned Investment Co**. vice president and CCO **Lisa Lauria** did in preparation for her last regular cycle exam. FINRA gave her a list of more than 50 items they needed before the exam, including sensitive data that needed to be encrypted before it could be delivered.

She was told to expect the review of the Indianapolis-based broker dealer to take two full weeks. Instead, it took just six days. "They told me it was because I had gathered, organized and labeled

(Indiana exam, continued on page 2)

A blueprint for FINRA? Third-party marketers approve best practices

Third-party marketing firms should make sure they conduct due diligence on prospective clients, looking at factors ranging from the client's history of litigation to staff turnover. That's just one of many suggestions made in the "Principles and Best Practices" document that the **Third Party Marketers Association** approved at a meeting last week in New York.

The document – obtained exclusively by *BD Week* last week – suggests standards for a segment of the industry that third-party marketers say is often misunderstood by others, including politicians. And the document gives **FINRA** a possible blueprint as the SRO goes about the task of crafting a rule to regulate the activities of this business model of broker-dealer.

"A lot of damage has been done in a relatively short period of time by a small number of bad

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Indana exam *(cont. from pg. 1)*

just about everything on their lists before they arrived, and made their requests during the time they were in the office a priority," she says.

Planned Investment Co.'s recent exam experience offers a window into the new FINRA "risk-based" exam process. As FINRA CEO **Rick Ketchum** said May 7, "in many ways, our examination and enforcement programs have profoundly changed with a substantial focus on fraud detection." Reiterating a point he made in a speech a week earlier, Ketchum said he expects examiners to become more familiar with differing business models of broker-dealers.

Examiners: 'Things have changed'

"They said things have changed," Lauria says, referring to the two examiners who conducted the review. "They were going to conduct a risk-based review, which meant they were focusing on our business model." The firm's business model, however, isn't unusual. It's a straightforward, dually registered firm.

The examiners were polite, but they also were as tenacious as "hound dogs," Lauria says. When they arrived, they plowed straight through to the exam, foregoing an in-depth interview with the management team as in the past.

Four years ago, when the firm had its previous exam, the examiners didn't seem to know as much about how things worked at the firm. Then, there was one senior and one junior examiner.

This time was different. Both examiners were experienced.

"These two people were very knowledgeable," Lauria explains. "They were very thorough, too. That's the part that scares you because when you know they know what they're talking about, and they keep asking and asking, you're like, oh man!!!!. It's different [from] having someone that you kind of have to say, 'Okay, this is the way this works.'"

AML and CEO certification

The examiners honed in on AML testing, checking annual CEO certification and on documenting whether privacy notices went out to all customers, Lauria says. They wanted evidence this was done – including the result of the AML independent tests – for the last four years. They also wanted to know the sources of money identified through the AML program.

"Supervision and fraud protection is a priority, so that would explain the CEO certification request," says **Steven Goldberg**, a principal in the New York office of the consulting firm **Grant Thornton.** He says FINRA has placed a high priority on AML programs.

Examiners also were intent on verifying transactions made over the last year, Lauria says.

"The examiners were able to verify the assets were invested accurately and correctly by asking for more documentation," Lauria explains. "From our trade blotter, the examiner chose a list of mutual fund trades in class A shares, class B shares, class C

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Indiana Exam *(cont. from pg. 2)*

shares, a list of college savings accounts, a list of muni bonds, etc. And for each list of about 20 transactions, I needed to present a copy of the check (if applicable), a copy of the trade order, copy of the confirmation, a copy of the statement and the suitability that was on file at the time of the order."

"This process was very time consuming to say the least," she continues. "But, it was very evident that the examiners intended to prove that the client's money was indeed invested accurately and within a reasonable amount of time."

"This is a direct result of the **Madoff** scandal," Goldberg says. "In that case, Madoff never actually made trades and sent customers phony trade tickets. [Examiners] are looking to confirm that trades were executed as directed and as the customer indicated."

The examiners didn't contact any of the firm's customers, but they told Lauria they might do that. No customers were approached, so Lauria surmises there were no red flags to cause examiners to take that step.

A particularly noteworthy, new area the examiners looked into were the time horizons for the share classes that customers had.

Protecting customer information

There also was intense focus on protecting customer information. "They wanted to see our vendor agreements and conducted an in-depth interview about our vendors' access to client information. The examiner wanted to know if we have a plan if a breach of information were to occur. They wanted to know how secure our office space is – is client information left in conference rooms or on desks unattended?" Lauria says.

Sales meeting memos

Another focus area was memos from sales meetings. "Maybe what they're doing is looking at how we train and what our sales topics are... to see if we're being thorough." Generally, wholesalers come in to do their training.

Goldberg offers an explanation: "A focus of FINRA over the past few years is around sales practices – improper sales practices were blamed for problems around marketing of auction rate securities a few years ago, and various derivative products among others. Marketing of structured products is also a focus of FINRA today."

Communication throughout exam process

A nice change Lauria says she noticed this time around was being informed immediately if the examiners thought there were problems. Also, the examiners allowed for some documents to be corrected while they were at the site.

"In the past, you didn't know about your findings until the exit interview," Lauria says. "What was really good about this exam is they gave me [updates] every day or two. Once they got through a subject, they would give me an update. And the one time when I got really tense, he said, 'If there's a finding, I'm going to let you know right away. We won't be holding that until the exit interview.' That was a change from how they had done it in the past, and it was good.

"I mean, that's a welcome change instead of sitting on pins and needles."

Lauria said there were no significant findings, no Letter of Caution and no fine. The couple of areas that needed correction have been satisfied, she said. ■

Ketchum wants to create conflicts disclosure regarding brokerage services

You're already required to disclose conflicts of interest associated with the products you sell. But eventually, BDs might also have to disclose conflicts related to the services they provide.

That's one of the visions shared by **FINRA** CEO **Richard Ketchum** at **SIFMA's** recent Compliance & Legal Division Annual Seminar.

Product-by-product disclosure doesn't adequately address customers' needs, he said. "It is time to develop plain-English disclosure about brokerage services, about the conflicts of interest that a broker faces when she offers any service to her customer, to allow the customer to make an informed investment decision."

Ketchum wants to require firms to provide customers such documents at account opening. He

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recommends that they be electronic, allowing customers to determine how much information they want by providing hyperlinks to additional information.

Conflicts disclosure for services wouldn't be a big deal for dually registered firms, which already have that disclosure information on the Form ADV, but it would be a bigger burden on small BDs that don't offer IA services, says **W. Hardy Callcott**, a partner in the San Francisco office of the **Bingham** law firm.

To prepare for such a change, small BDs should gather Form ADVs from firms that have a similar business to see what they disclose in terms of potential conflicts, Callcott recommends.

"But that's only a first step," Callcott continues. "Every firm is different and you've got to tailor the disclosures to the specific circumstances of your firm. It requires you to think broadly about all the sources of compensation that the firm and its brokers receive, and all the different potential incentives they create."

Ketchum said creating the new disclosure document won't be easy. He noted that the Form ADV is long and complicated, and he suspects that most investors don't read it. Instead, Ketchum said he wants industry to work with FINRA to create a "simplified, plain English, disclosure about the services that you provide and the conflicts of interest that you may face."

Duke Law School Professor **James Cox**, who has followed securities litigation for four decades, says disclosure should be limited to what's relevant to the investor, especially when dealing with retail investors who are just buying or selling stocks and bonds. "You don't want to have a laundry list of everything the investment bank does that owns the broker-dealer because nobody's going to read it," Cox warned.

But some things should be clearly disclosed, he says. For instance, if a firm is trying to encourage a client to trade on margin, the firm should disclose that it makes more money under that arrangement than when the customer doesn't trade on margin, he says.

Cox says collateral disclosure certainly is needed when dealing with customers who have derivative or exotic products – and with issues like those involving **Goldman Sachs.** The SEC has accused Goldman of misleading investors by not telling them about the role that a major hedge fund played in selecting a portfolio that the hedge fund had bet against.

If a firm has a definite plan to short something, then that ought to be disclosed to affected investors, Cox says.

Still, disclosures should not be "a blanket laundry list" of things that include services that don't apply to the client, Cox adds. ■

Third-party marketers *(cont. from pg. 1)*

actors," said association president **Donna DiMaria**, apparently referring to pay-to-play scandals in places such as New York and California.

"At [the Third Party Marketers Association], we believe that, as the industry's only trade association, it is our responsibility to help restore the credibility of third-party marketers who are operating in a professional and ethical manner."

The best practices document isn't "a code of ethics in the sense that somebody is going to police people," says **Frank Minard**, the chairman of the association's strategy committee. Instead, they are suggested practices for firms to follow. The association does, however, want its members to adhere to the standards. Member also will have to be registered with a regulator such as FINRA, the SEC, or a state.

Here's a rundown of just a few of the best practices the association issued:

Due diligence on prospective clients – In addition to looking at the client's staff turnover and litigation, check out factors such as ownership changes, financial condition, and the firm's regulatory registrations.. Make sure the firm's philosophy, strategy, and decision-making process are clear. When evaluating the firm's performance and risk statistics, check on the calculation methodology that was used – and its compliance with industry standards such as Global Investment Performance Standards.

Preparing a marketing plan – The marketing strategy you create for the investment manager should include information on current market

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Third-party marketers *(cont. from pg. 4)*

environment, competitive position, potential target markets, and whether the product is suitable for the identified prospects.

Sales plan – The third-party marketer and the product sponsor should review the sales materials to make sure they comply with regulatory rules and industry guidelines. These reviews should be handled by compliance pros and documented. Also, third-party marketers should put their fee disclosure in all marketing materials.

While the sales plan is being executed, document current information about prospective investors to make sure the investment that was recommended is consistent with the investor's risk tolerance, investment experience, financial condition and other investments owned.

Client services – If you're providing ongoing client service, make sure there's a way to receive client and portfolio information in a timely and accurate way. "It must be recognized that a continuing assignment assumes that the member will be conducting and evaluating this information as though it were a continuing due diligence process," the document says.

Business management

In terms of third-party marketers' internal business operations, the association suggests there be one individual clearly designated as responsible for business ethics and compliance issues. That person should have direct access to senior management and be required to provide regular compliance reports at least annually. Among other business management issues:

✔ Make every effort to keep a record of all marketing contacts made, including physical or telephone contacts, hard copy mailings, electronic mailings, and due diligence materials. Archive these in a place other than the principal place of business;

✔ Have a business continuity plan that's communicated to clients and prospective investors;

✔ A compliance pro should sign off on what's posted on your company's website;

✔ Maintain ongoing continuing education.

The best practices also contains several provisions calling for firms to adhere to industry rules and regulations, and even definitions to distinguish the activities of a third-party marketer from other professionals such as lobbyists and placement agents. ■

Kimelman *(cont. from pg. 1)*

The case against Kimelman & Baird began when FINRA's Market Regulation Department conducted a regulatory review to check the firm's compliance with MSRB's rule on excessive commissions (Rule G-30[b]). The SRO looked at transactions from April 1, 2008 through June 30, 2008.

During that period, there were five transactions in which the commission charge "was in excess of a fair and reasonable amount," the settlement says.

The commission for each of the five trades was 2.5%, even though the volumes from the transactions ranged from 20 bonds to 100 bonds, Thetford noted. "I think I would have graduated these commission charges," he says.

To avoid what happened to Kimelman & Baird, remember the factors the MSRB rule says you're supposed to consider when determining commissions. These were pointed out in the AWC, and they include:

✔ the availability of the securities;

✔ the expense of executing the order;

✔ the value of the service your firm renders; and

✔ the amount of other compensation you receive from the transaction.

FINRA says the firm's supervisory system was faulty in that the WSPs didn't state: 1) how often the designated supervisor should take the needed steps to comply with the MSRB rule against excessive commissions; or 2) how completing the steps in the WSPs should be documented.

"The simple, practical part is you've got to put it in writing in the procedures," Thetford says.

As for training, Thetford says there's "no single answer" on how often firms should train supervisors and reps, but suggests it be done at least annually. You should provide training in the interim if you see signs that reps or supervisors aren't complying with the procedures, he adds.

(Kimelman, continued on page 6)

Kimelman *(cont. from pg. 5)*

Especially in this post-Madoff era, all firms should have a "serious mechanism to check and surveil the prices being charged by their RRs," says **Rick Nummi**, general counsel and managing consultant of **Accounting and Compliance International**, a consulting firm based in New York.

"If one carefully examines the disciplinary actions, it is pretty clear that weak WSPs are the number-one cited item on almost each FINRA action," Nummi says. FINRA examiners "certainly aren't keeping their focus secret," he adds. He says this action shows that you can't 'fudge' in crafting those procedures.

Kimelman & Baird has no related disciplinary history. The firm's CCO didn't respond to a *BD Week* request for comment.■

Industry speaks out against proposal to broaden *BrokerCheck* disclosures

FINRA's proposed expansion of information that's available on *BrokerCheck* goes too far, say industry interests in comments on the proposal that were submitted to the self-regulatory organization by last week's deadline.

Meanwhile, state securities regulators and investor advocates maintain that the proposal would be an improvement that doesn't go far enough.

FINRA has been gradually increasing the amount of information available on *BrokerCheck*, a change consistent with the increased interest in investor protection in this post-**Madoff** era.

The posting of historic complaints – complaints that haven't been adjudicated and were at least two years old as of as of March 19, 2007 – should be removed from the proposal because many of them have been shown to be meritless or have been abandoned by the investor, said **Lisa Roth**, chair of the Member Advocacy Committee of the **National Association of Independent Broker-Dealers**.

A similar worry was mentioned by **Deborah Castiglioni**, the CEO and CCO of **Cutter & Company, Inc.**, based in Ballwin, Mo. "Many complaints are filed and never followed up on by the client," Castiglioni said. "Under the expansion proposal, these stale complaints that have never been fully adjudicated will be listed on this regulatory disclosure vehicle unendingly."

If FINRA chooses to implement the provision as proposed, she said, FINRA should clearly mark the area of *BrokerCheck* that displays that information as unproven allegations, she said. Roth had a similar request.

FINRA also has proposed a process to dispute the accuracy of information disclosed through *BrokerCheck*, something that Roth said her organization supports. But she said there should be a timeline for individuals to submit a request for a change – and for FINRA to respond.■

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