A Conflicts-Based Approach to SEC and FINRA Priorities
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A Conflicts-Based Approach to SEC and FINRA Priorities

March 31, 2015
Presented By
Julie K. Glynn, JPMorgan Chase & Co.
Daniel A. Nathan, Morrison & Foerster LLP
The Current Landscape

• Momentum pushing towards adoption of a uniform fiduciary standard
  • Dodd-Frank
  • Department of Labor
  • SEC
  • NY State Comptroller

• Securities Regulators Build-Up
  • Conflicts Report
  • Adoption of Standard

• Today we will look at several SEC and FINRA current (and perennial) priorities through the lens of Conflicts of Interest.
Agency Pronouncements

- FINRA Conflicts Report
  - Putting Customer Interests First
- FINRA 2015 Priorities Letter
  - Best Interests of the Customer
- SEC 2015 Priorities letter
- Carlo Di Florio, FINRA Chief Risk Officer and Head of Strategy – October 2014 Speech
  - Effective Conflicts Management Framework
Other Examples of Conflict-Based Focus

- FINRA Sweep of Order Routing Practices (announced July 9, 2014)

- Research Analyst -- Toys R Us IPO cases (Dec. 11, 2014)
Drilling down on Conflicts

• Examples of Conflicts
  • Firm vs. client conflicts -- recommending products for which firm receives greater fees, or may be unsuitable; firm plays multiple roles in a transaction
  • Client vs. client conflicts – when broker represents clients with countervailing positions.
  • Employee vs. client conflicts

• Complex Products
  • 12-03
  • KYD, Disclosure, Reasonable Basis Suitability

• Wealth Events
  • Reverse Churning
  • IRA Rollovers
Processes for Handling Conflicts

- Report Recommendations
- Conflicts in Commissions/Compensation
- Mitigation of conflicts
Uniform Fiduciary Standard

• What would it look like?
• Current standards
• How are conflicts treated?
• What would need to be harmonized?
Client Alert

January 8, 2015

FINRA Issues a Packed Priorities Letter for 2015

By Daniel Nathan and Kerry Jones

FINRA opened 2015 with a lengthy and ambitious agenda of regulatory priorities. This year's Regulatory and Examination Priorities Letter is much longer than those issued the last two years, and repeats many of those years' priorities, while adding additional products and practices. Amidst this smorgasbord of priorities, several are highlighted in FINRA's accompanying press release, and so might have a favored place at the table:

- sale and supervision of interest-rate-sensitive and complex products, including alternative mutual funds;
- controls around the handling of wealth events in investors' lives;
- management of cybersecurity risks;
- treatment of senior investors; and
- high-risk brokers and removing bad actors from the securities industry.

In the letter, FINRA seeks to unify its priorities around a set of systemic issues that it believes differentiate good firms from non-compliant firms: putting customer interests first; firm culture; supervision, risk management and controls; product and service offerings; and conflicts of interest. FINRA will use data analytics to identify potential problem areas within firms, and expects firms to use similar methods to identify problems themselves.

We summarize below some of the more significant issues raised in the letter, along with our recommendations about how to prepare for a risk-based FINRA examination of these issues. As always, the best way for a broker-dealer to prepare for a FINRA examination and avoid enforcement interest is for the firm to put itself in the head of a FINRA examiner and address the areas that FINRA is likely to examine in light of the firm's business, history and supervisory structure.

SALES PRACTICES

Conflicts of Interest - Since issuing its October 2013 Report on Conflicts of Interest, FINRA often expresses its regulatory concerns in terms of conflicts of interest. While FINRA states in the letter that it has seen recent positive improvement in broker-dealers' focus on conflicts, this continues to be an area of active enforcement.

- Recommendation - Almost any broker-dealer activity, and certainly any time that a broker is on the other side of a securities transaction from a customer, might be viewed as presenting a potential conflict of interest. Firms should therefore take a top-down, enterprise-wide approach to identifying and addressing conflicts, and document their efforts. More helpful information in this regard can be found in our Client Alert.

Private Placements - FINRA continues to find fault with the due diligence done before private placements, building on themes strongly established in the series of cases related to the failed Medical Capital Holdings and Provident Royalties offerings. This unquestionably will continue to be an area of focus.
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- Recommendations-
  - Firms must ensure that they are complying with due diligence procedures and acquiring enough information to support a determination that the investment is suitable not only for specific customers but for any customer.
  - If there is a contingent offering, firms must ensure that investor funds are held in escrow at an independent bank and that if the condition is not met, a rescission offer is properly conducted.

Product-Related Risk Reviews - As in previous years, FINRA lists the products that are causing it the most heartburn, as well as identifying the issues common to all product-related risk reviews: due diligence, suitability, disclosure, supervision, and training. FINRA identifies the following products as being of particular interest:

Interest Rate-Sensitive Fixed Income Securities - FINRA continues to be concerned with the impact of the unusually low interest rate on customers holding interest rate-sensitive products. In 2015, FINRA will be on the lookout for firms with concentrated positions in products that are highly sensitive to interest rates, such as long-duration fixed income securities, high yield bonds, mortgage-backed securities, or bond funds. In particular, FINRA will look closely at floating-rate bank loan funds, which retail investors are increasingly using to protect against the threat of rising interest rates. However, according to FINRA, floating-rate bank loan funds carry risks such as credit and call risk, difficulty with valuation, longer settlement times, and illiquidity, and these risks must be addressed with customers.

  - Recommendation-In marketing interest rate sensitive products, firms should ensure that their communications with customers, suitability reviews, and broker training address the potential impact of interest rate changes on the price of the product. In addition, firms should ensure that other risks inherent in these products are adequately disclosed.

Variable Annuities - Both new purchase and 1035 exchange variable annuities will be a priority for FINRA in 2015. FINRA’s review will include: assessments of compensation structures to determine if they result in improper sale incentives, suitability of recommendations, statements made by registered representatives about these products, adequacy of disclosures made about material features of variable annuities, and an analysis of the design and implementation of procedures firms use to train their employees on compliance. Examinations will particularly focus on the sale and marketing of “L share” annuities.

  - Recommendation-Firms should have in place compliance procedures and training by compliance personnel to ensure brokers have sufficient knowledge to provide full and accurate disclosure to customers and sell them appropriate products. Supervisors should also have product knowledge to prevent and detect problematic sales.

Alternative Mutual Funds - FINRA plans to increase its review of sales of alternative mutual funds in the wake of an increase in these sales from less than $50 billion in 2008 to $300 billion in 2014. FINRA noted that alternative funds are marketed as a sophisticated product that allows retail customers to invest in a hedge-fund like product. FINRA worries that some retail customers may not fully understand how alternative funds could respond to different market conditions.
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- **Recommendation**-Firm communications regarding funds whose strategies involve non-traditional asset classes, non-traditional strategies or illiquid assets must accurately and fairly describe how the products work and that explanation must be consistent with the representations in a fund’s prospectus. This can be particularly difficult given the complexity of strategies followed by certain alternative funds. The need for concise risk disclosure in this area has also been identified as a priority of the SEC staff (see our recent blog entry).

*Non-Traded Real Estate Investment Trusts (REITs)* - FINRA continues to have concerns with the high fees, liquidity, and valuation difficulty inherent in these products. REITs were a priority last year and as a result new rules were passed by both FINRA and the SEC requiring broker-dealers to provide a more accurate per share estimated value on customer account statements, in addition to other disclosures. These changes will go into effect on April 11, 2016.

- **Recommendation**-Firms should perform due diligence on an ongoing basis for all REITs they recommend.

*Structured Retail Products (SRPs)* - FINRA is concerned that these complex, less-traditional products present investors with unique or unfamiliar risks, especially given the uncertain impact of a changing interest rate environment. In particular, FINRA will be looking at incentives to increase revenues from product sales through distribution channels that may not have adequate controls and conflicts that might arise where the distributor and wholesaler are affiliated companies.

- **Recommendation**-Wholesalers should have robust Know-Your-Distributor policies and procedures designed to ensure there are adequate controls and systems in place to mitigate the risks created by sales incentives.

*Securities-Backed Lines of Credit (SBLOCs)* - These are revolving non-purpose loans that allow investors to borrow using fully paid-for securities held in brokerage accounts as collateral. As more firms offer SBLOCs, FINRA is increasing its scrutiny and wants customers to be fully aware of how changing market conditions can lead to collateral shortfalls that may affect their brokerage accounts and their ability to draw on the SBLOC.

**SUPERVISION**

**Timely Reporting of Disclosable Information** - FINRA is concerned that firms are not timely filing required U4 and U5 updates. As a result, available information may not be accurate and useful to appropriately advance investor protection. To increase compliance, FINRA will be making changes to its registration review process, rules, and examination program. FINRA will also be checking member firms to ensure they are complying with recent amendments to Rule 3110, which require firms to perform public records checks when registering associated persons to verify the accuracy and completeness of U4 filings. The amended Rule goes into effect in July 2015.

**New Supervision Rules** - On December 1, 2014, FINRA’s new supervision rules came into effect, modifying requirements related to:

1. Supervising offices of supervisory jurisdiction and inspecting non-branch offices;
2. Managing conflicts of interest in a firm’s supervisory system;
3. Performing risk-based review of correspondence and internal communications;
4. Carrying out risk-based reviews of investment banking and securities transactions;
5. Monitoring for insider trading, conducting internal investigations and reporting related information to FINRA; and
6. Testing and verifying supervisory control procedures.

- **Recommendation**—FINRA has flagged these areas as topics it will focus on in its examinations, so firms should review their entire compliance program and make sure it is consistent with the new rules. *For a further discussion of the new rules, see our Client Alert.*

**High-Risk and Recidivist Brokers** - FINRA continues to increase regulation to protect the public from brokers engaged in misconduct or unreasonably high risk investments. FINRA will continue to use data mining, analytics, specially targeted examinations, and expedited investigations and enforcement actions to remove these high-risk brokers from the securities industry.

- **Recommendation**—Firms should evaluate their hiring policies to determine if they are rigorous enough to ferret out unduly risky brokers before they are hired. Firms also need to adequately supervise their employees to ensure employees are not engaging in these practices. Also, firms should familiarize themselves with the new rules.

**Individual Retirement Account (IRA) Rollovers and Other “Wealth Events”** - Given the growing number of Americans approaching retirement, FINRA is increasing scrutiny of the controls in place at firms related to wealth events, especially IRA rollovers. In particular, FINRA will be looking at the advice and recommendations made to customers surrounding these rollover events. FINRA will also be looking closely at firm policies to ensure that they appropriately address the unique challenges faced by elderly investors.

- **Recommendations**-
  - Firms should develop policies to ensure compliance with their supervisory, suitability, and disclosure obligations for wealth events. Firms should especially ensure that no communications with customers imply that a retiree’s only sound option is rolling the plan over to an IRA managed by the broker-dealer. *See our Client Alert for an extensive discussion of this issue.*
  - Firms should train their employees on how to meet the needs of elderly investors, including a discussion of issues surrounding diminished capacity and elder abuse. *For more on this issue see our Blog Post.*

**Anti-Money Laundering (AML)** - AML will continue to be a major FINRA priority. Twelve years after FINRA first instructed the industry on these requirements, in Notice to Members 02-21, FINRA continues to find substantial gaps in firms’ procedures. FINRA demonstrates the importance of this information-gathering tool by pointing to the over 700 AML referrals to the SEC and other law enforcement agencies last year.
This year, FINRA will focus on Cash Management Accounts (CMAs) -- brokerage accounts used for activity typically associated with bank accounts -- and in particular the failure of firms to identify potentially suspicious transfers and verify the business purpose of activity conducted through those accounts. FINRA has noticed an increase in microcap activity and foreign currency conversion related to Delivery versus Payment/Receipt versus Payment (DVP/RVP) accounts and wants to make sure firms are monitoring them closely.

- **Recommendations**-
  - Firms should monitor accounts carefully to identify potentially suspicious transfers, and surveillance methods should be tailored to the specific risks inherent in a firm's business lines, products, and customer bases.
  - In particular, firms should monitor CMA accounts to verify the business purpose of activity conducted through those accounts and monitor DVP/RVP accounts to ensure that securities being sold are registered under Section 5 of the Securities Act of 1933 or the transaction is subject to an exemption from regulation.

**Cybersecurity** - With FINRA’s focus on obtaining information on cybersecurity practices, we anticipate that 2015 will include new suggestions and/or regulations regarding cybersecurity. In particular, FINRA is concerned with cyber-attacks that destroy data, and wants to make sure that the electronic recordkeeping requirements under SEC Rule 17a-4(f) are enough to protect records in the event of a cyber-attack.

- **Recommendation**-Firms should ensure that their cybersecurity policies are ready to handle the cyber threats of 2015. They should also be on the lookout for FINRA’s review of cybersecurity policies which is due out the beginning of this year and which will likely include additional suggestions for best practices. For more recommendations on cybersecurity, see our Client Alert.

**Outsourcing** - As firms outsource more key operational functions, FINRA wants to make sure that they know that outsourcing does not diminish a broker-dealer’s responsibility to comply with applicable federal security laws and regulations, as well as FINRA and MSRB rules and to supervise a service provider’s performance.

**CONCLUSION**

As firms prepare for 2015, they put themselves in the best position to prepare for examinations and avoid enforcement interest when they are aware of FINRA’s priorities. FINRA expects firms to be the first line of defense, so firms need to be monitoring their own data for potential misconduct. Strong internal compliance practices and an awareness of FINRA’s examination priorities will help firms position themselves for a 2015 in which stress is limited to the extent possible in a regulated environment.
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OCIE Publishes Exam Priorities for 2015

By Kelley A. Howes

The National Exam Program of the SEC's Office of Compliance Inspections and Examinations (OCIE) published its examination priorities for 2015 this week. (Last week, FINRA published its priorities, discussed here.) Many of the themes are consistent with OCIE's 2014 priorities and issues identified by the staff over the course of the last year. One notable new theme is OCIE's recognition that transfer agents are "gatekeepers" that warrant the staff's attention. OCIE also encouraged would-be whistleblowers to reach out to the staff with information about activities that may "violate the federal securities laws or otherwise [operate] to harm investors."

OCIE listed three key areas of focus in 2015:

Retail Investors. OCIE continues to raise concerns about retirement investing and the use of traditionally "institutional" products in the retail marketplace, including these examination priorities:

- Financial professionals that register as investment advisers or as dual registrants can offer a variety of fee structures depending upon the types of services or products offered to clients. OCIE will focus on whether advisers are making recommendations based on a client's best interests or the adviser's own self-interest. We've previously examined this issue (see our client alert regarding scrutiny of "reverse churning") and it continues to be an area of focus.

- As we recently noted, the Division of Investment Management is concerned that alternative investment companies may not adequately disclose their risks to retail investors. OCIE apparently shares the Division's concern and will examine issues related to sales of alternative products to retail investors, including valuation, liquidity, leverage, a fund's internal controls, the empowerment of a fund's board and compliance staff and how the funds are marketed.

- OCIE will continue to evaluate whether fixed-income investment funds have adequate controls to ensure that their disclosure is not misleading and that their investments and liquidity profiles are consistent with such disclosure, in light of anticipated increases in interest rates. Liquidity of fixed-income funds is another recurring theme from the Division of Investment Management this year; clearly the Division has OCIE's ear.

Market-Wide Risks. One of the SEC's three missions is to maintain fair, orderly and efficient markets. In support of that mission, OCIE will focus certain examinations on structural risks and trends involving multiple firms.

- OCIE, together with the Division of Investment Management and the Division of Trading and Markets, will continue to actively monitor the largest U.S. broker-dealer and investment advisory firms, focusing not only on firm-specific issues, but on early identification of issues across the industry.

- OCIE's focus on cybersecurity will be expanded to include transfer agents.
• OCIE will evaluate firms’ use of various trading venues to determine if they appropriately reflect best execution obligations, or if firms are making trading decisions based on payments or credits for order flow.

• Like FINRA, OCIE will focus on broker-dealers’ and investment advisers’ supervision of registered representatives and financial adviser representatives in branch offices. See our recent advice on implementing a strong branch office supervisory program and dealing with a regulatory branch exam.

Data Analysis. Consistent with its 2014 priorities, OCIE intends to continue to develop and use its enhanced data analytics to identify firms that appear to be engaged in fraudulent or other illegal activity.

• OCIE will use its analytical capabilities to identify those firms that hire individuals with a record of misconduct. Firms should review their own hiring records to determine if they are likely to draw OCIE’s attention.

• OCIE will use its data from clearing firms to identify brokers that are engaged in excessive trading.

• OCIE will also use such data to examine operations of broker-dealers and transfer agents to uncover incidences of market manipulation.

• In a novel use of reporting data, OCIE will seek to determine whether firms have failed to file Suspicious Activity Reports, or filed them late.

Other Priorities. OCIE emphasized themes covered in previous announcements:

• Newly registered municipal advisors;

• Never-before examined investment companies; and

• Fees and expenses charged by private equity firms.

In addition, OCIE identified transfer agents as “important gatekeepers to prevent violations of Section 5 of the Securities Act [of 1933] and other fraudulent activity.” Transfer agents would be well-advised to carefully examine their compliance programs in anticipation of hearing from SEC examiners this year.

Our Take. Little in the 2015 examination priorities letter should come as a surprise, but the planned use of data and the broad-based review of supervisory issues will continue to create challenges for regulated entities.

In the case of broker-dealers and entities that are dually registered investment advisers/broker-dealers, these challenges can be particularly acute. For example, FINRA’s increase in the amount of data it gathers and reviews could impose significant additional burdens on member firms. Are FINRA and the SEC coordinating their data gathering? Or will variations in the data requests require that multiple recordkeeping and reporting systems be implemented?

While OCIE will scrutinize transfer agents as gatekeepers, regulatory guidance for transfer agents is relatively limited. We’ve heard that updating and modernizing the regulatory structure around transfer agents is a priority for the SEC’s policy staff, but that could take some time (and will hopefully fully involve the industry’s input). In the meantime, we fear the SEC may opt to regulate by enforcement.
Regulated entities should heed the statement of Andrew Bowden, OCIE’s Director: “We have observed that when we share our areas of focus, many industry participants independently review their controls in the areas we have identified.” We suggest that regulated firms do so before OCIE pays them a visit.

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October 15, 2013

FINRA Tells Broker-Dealers How to Better Manage Conflicts of Interest

By Jay Baris and Daniel Nathan

A much-anticipated FINRA report concludes that broker-dealers must do more to manage conflicts of interest.

FINRA said that the report, published on October 14, 2013, highlights “effective conflicts management practices that may go beyond current regulatory requirements and identify potential problem areas,” according to the statement of FINRA CEO Rick Ketchum.

The report focuses on how firms can strengthen their conflicts frameworks, starting with a “tone from the top” and flowing through the firm’s structures, policies, processes, training and culture. FINRA states that the report emphasizes the process of and approach to identifying and managing conflicts, rather than listing an inventory of conflicts that firms face.

Conflicts of interest have long been a focus of FINRA. (See the discussion of FINRA’s historic statements about conflicts of interest in our prior Client Alert.) The new report states that conflicts can arise in any relationship where a duty of care or trust exists, and therefore they are widespread across the financial services industry. FINRA inventoried the conflicts that firms reported in response to the July 2012 sweep request across several broad categories, including “General Conflicts” (such as outside business interests, or gifts and entertainment), “Supervision and Compliance Conflicts” (between a firm’s oversight roles and revenue generation objectives), “Research-Related Conflicts” (including pressure from investment bankers or issuers), “Banking and Capital Markets” and “Retail/Private Wealth.”

In the end, FINRA focuses on three approaches to identifying and managing conflicts:

• enterprise-level frameworks to identify and manage conflicts;
• approaches to handling conflicts in manufacturing and distributing new products; and
• approaches to compensating brokers.

The report summarizes best practices that FINRA observed related to each of these approaches, and attempts to distinguish between procedures at large and small firms. The best practices include the following:

• set a “tone at the top” that emphasizes the importance of ethical behavior and carries through to the entire organization;
• establish independent product review processes that are independent from the businesses that propose the products;
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- avoiding pressure to favor proprietary products or other products that offer the brokers better compensation terms;
- minimizing conflicts in compensation structures, and using heightened supervision to mitigate remaining conflicts; and
- using hiring practices and training to ensure that the firm’s brokers treat customers ethically.

True to FINRA’s word, the release of this report does not appear to be accompanied by any informal or formal activity against any particular firms. Moreover, in boldface type, FINRA stresses that it does not intend to express any legal position, and does not create new legal requirements or change any existing regulatory obligations. FINRA ominously notes, however, that as it continues to review how firms manage conflicts, if it finds that firms have not made adequate progress, it will evaluate rulemaking to require reasonable policies in this area. In this spirit, FINRA’s report may indicate how FINRA interprets existing compliance obligations, and could serve as a roadmap for evolving enforcement cases.

Please also see our companion article, “FINRA’s Report on Conflicts of Interest: Issues for the Structured Products Market.”

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SEC Intensifies Scrutiny of Fee-Based Accounts and Reverse Churning

By Daniel Nathan and Lauren Navarro*

The SEC is crunching a lot of data these days, and it apparently intends to use some of that data to identify “reverse churning.” Reverse churning is the practice of placing a client who trades infrequently in a fee-based, rather than a commission-based, account. Chair Mary Jo White recently identified this as a problem that the SEC can detect through its quantitative analytics.

Based upon the SEC’s and FINRA’s past regulatory and enforcement focus in this area, we recommend that firms review their supervisory systems and procedures to ensure that they are adequate to identify possible instances of reverse churning before the regulators do. Evaluation of the appropriate use of fee-based accounts is very likely to be an SEC exam priority in the coming year.

THE SEC’S ENHANCED USE OF DATA

At the annual meeting of the National Society of Compliance Professionals (NSCP) in October, White reported that the SEC’s examination program continues to improve the implementation of a risk-based strategy that focuses on entities and business practices that the SEC believes pose the greatest risks to investors and markets.¹ She pointed to the Risk Analysis Examination (RAE), which uses quantitative analytics to examine clearing firms and large broker-dealers. She said that the examination staff may require such firms to download all transactions cleared by a firm over the prior year or two, and the RAE subjects the data to a broad range of queries designed to identify problematic behavior.

Chair White reported that in one recently completed exam, the RAE team collected and analyzed over 400 million transactions, and she stated that she expects that future exams will analyze more than twice that many. Armed with this data, the RAE team is – and has been – able to identify a wide range of problematic behaviors including reverse churning, as well as unsuitable recommendations, misrepresentations and inadequate supervision.

THE PROBLEM: REVERSE CHURNING

Fee-based accounts may be desirable when they align the interests of the client and the firm in building assets in an account. Fee-based accounts also may offer some clients a greater variety of services, such as long-term financial planning and money management. Conversely, in a transactional or commission-based account structure, brokers are incentivized to make trades, even at the expense of a client’s best interests.

However, fee-based accounts (also known as asset-based, or “wrap-fee” accounts) also ensure a stream of revenues to broker-dealers from clients that are less active traders or that have relatively small account balances (e.g., less than


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$50,000). For these clients, an annual fee might not make economic sense.

In short, fee-based accounts may not be the best fit for certain clients if annual fees end up costing more than the trading commissions that would have accrued in accounts that show little to no activity. The practice of putting – or leaving – customers in fee-based accounts despite a low level of trading or assets that does not justify the fee, is known as “reverse churning.”

REGULATORY CRACKDOWN: FINRA AND SEC GUIDANCE AND ENFORCEMENT REGARDING FEE-BASED ACCOUNT SUPERVISION

In 2003, FINRA’s predecessor, the NASD, reminded members that they must have “reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, cost, and customer preferences.”2 The NASD directed members to implement supervisory procedures to require periodic review of fee-based accounts to determine if they remain appropriate for customers owning them. Absent unusual circumstances, the NASD stated, these reviews should be conducted annually. The NASD also explained that just because a customer would have been billed less in a commission-based account is not conclusive evidence that the fee-based account was inappropriate; however, such a finding should cause the member to give careful scrutiny to the cost issues.

Firms offering fee-based accounts are required by FINRA rules to develop and implement a supervisory system and written supervisory procedures reasonably designed to monitor their fee-based accounts and the activity in them. Such supervision is necessary to determine if the fee-based account structure remains appropriate for customers, taking into account the services provided, cost and customer preferences.

From 2007 to 2009, FINRA was more active in disciplining violations of this obligation. In general, the FINRA cases in this area allege a failure to supervise. In some instances, FINRA also found violations of its fair pricing rule. In addition, FINRA sanctioned some firms for improperly double-charging clients with fee-based accounts, that is, charging clients the annual fee in addition to a transactional or commission-based fee for the same asset. The following FINRA/NASD cases illustrate the regulator’s focus in this area:

- In one case, FINRA found that a broker-dealer failed to establish and maintain a supervisory system to determine whether fee-based accounts were more economical for the customer than standard commission-paying accounts. As a direct result of this lack of supervision, the firm allowed roughly 19 customers to continue in fee-based accounts without determining whether they were appropriate for the customers. For two years, no trades were conducted in 16 of these accounts, but the firm received about $73,853 in fees. Moreover, although the firm required a minimum of $50,000 to opt into the fee-based structure, many of the customers had less than $25,000 for at least one year during the review period. Until 2005, the firm had no review process in place once an account was opened, so if a customer did not conduct any trades in an account this inactivity was never reviewed by a principal. In addition to other penalties, this firm was fined $50,000 for its violation.

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- In another case, FINRA found that as a result of a firm’s failure to establish and maintain an adequate supervisory system to monitor its fee-based brokerage business, approximately 594 customers conducted no trades in their fee-based accounts for at least two years. These same customers paid the firm about $1.9 million in fees. In addition, about 620 customers held assets that remained below the $50,000 benchmark and averaged less than $25,000 for at least one full year during the review period. FINRA fined the firm $2 million.

- In a similar case, the only supervisory procedure involved review by a principal of the decision to open a fee-based account, but this review was found to be essentially meaningless. From February 2001 through June 2005, approximately 847 of these accounts had no trades during two or more consecutive calendar years, but were charged $2.6 million in fees during the years of inactivity. FINRA fined the firm $1.2 million.

- In another case, FINRA found that a firm failed to specify benchmarks for customers for whom fee-based accounts would be appropriate, and did not adequately monitor such accounts to ensure that they remained appropriate on an ongoing basis. As a result, during a three-year period, the firm opened over 2,644 wrap-fee accounts without adequately evaluating whether such accounts were appropriate or economical for its customers. Subsequently, the company failed to adequately monitor these accounts. As a result, FINRA found that in at least thirty-six accounts no trades were made for at least eight consecutive quarters. Nevertheless, these accounts were charged over $129,000 in fees during these quarters. FINRA also found that the company failed to establish a supervisory system designed to protect its wrap-fee customers from being assessed both a transactional fee and an annual fee. Specifically, in 932 cases, the firm double-charged customers both a commission and a fee on the value of the asset purchased. The firm was fined $700,000 for these violations.

The SEC has also tightened scrutiny on fee-based accounts and double-charging. For example, in one case the agency found that a broker-dealer/investment adviser had charged undisclosed fees to wrap-fee clients. In effect, the clients who maintained fee-based accounts were subjects of duplicative commissions. The SEC found that the firm committed fraud by charging both wrap fees and commissions. In another matter, clients in wrap-fee investment advisory programs contracted with the firm to pay one “wrap” fee for advisory, execution, clearing and custodial services except as specifically provided in their written advisory agreements. However, the SEC found that in at least 5,764 separate transactions, the firm charged commissions on a transactional basis in addition to the wrap fees.

At least one federal court has found that brokerage firms offering wrap-fee accounts owe customers a fiduciary duty. The Tenth Circuit, in Geman v. S.E.C., held that in shifting client assets to a fee-based structure, a firm must act as a fiduciary and justify the annual fee. In other words, if a firm wants to move a client into a fee-based account, it must be able to justify the move as economical.

COMPLIANCE: TOUGHER REGULATION CONTINUES

The SEC’s continuing interest in reverse churning and double-charging, and its use of new examination and investigation tools, together suggest that the future will see more investigations and enforcement actions against firms who place

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3 Geman v. S.E.C., 334 F.3d 1183, 1189 (10th Cir. 2003) (holding that the brokerage firm owed its wrap-fee customers a fiduciary duty, even if it was not acting as an investment advisor with respect to transactions at issue, because customers’ response to firm’s promotional material, which included statement that firm would provide brokerage, advisory, and custodial services in return for customers’ payment of “all-inclusive” fee, calculated as a percentage of a customer’s assets under management, established an agency relationship, thus invoking fiduciary responsibilities).
clients in a fee-based or ‘wrap-fee’ system. Monitoring accounts to ferret out reverse churning has proven difficult for firms in the past, since spotting inactivity might be more challenging than detecting excessive trades (known as “churning”). However, given Chair White’s remarks to the NSCP, it seems that the SEC and its staff are willing to do what it takes to find and remedy these violations.

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Client Alert

January 2, 2014

Retirement Funds Rollovers: FINRA Ends 2013 By Identifying Its First 2014 Priority

By Daniel A. Nathan

It is the end of the year, and many people are thinking about the status of their retirement accounts and planning any changes to their investments. FINRA also has retirement accounts on the brain. It is thinking about the ways member firms recommend investments in retirement accounts, and planning what to do about that.

FINRA recently issued Regulatory Notice 13-45, giving notice that one of its examination priorities in 2014 will be reviewing firm practices when recommending a rollover of assets from an employer-sponsored retirement plan to an IRA.

THE SECURITIES RECOMMENDATION

According to FINRA, when a participant in an employer-sponsored 401(k) retirement plan changes employers, he or she has four options:

• leave the money where it is;
• roll the assets to the new employer’s plan (if possible);
• roll the assets over to an IRA (by far the largest source of contributions to IRAs); or
• cash out the account, which could have tax penalties and unfavorable tax treatment if the employee is under 59½ years old.

When making this decision, many investors seek the advice of a financial advisor, who may be a registered representative of a broker-dealer. If a broker-dealer recommends that an investor roll over retirement plan assets to an IRA, or otherwise engages in marketing IRAs, it typically makes securities recommendations. These activities are subject to FINRA rules.

THE RELEVANT CONSIDERATIONS

The Notice lists the following considerations relevant to any recommendation to roll over assets from a 401(k) plan to an IRA:

• an increased range of investment options available under an IRA (although FINRA notes that a 401(k) plan’s more limited options might be preferable if they include low-cost institutional funds);
• the amount of the expenses and fees charged by the 401(k) plan versus any IRAs under consideration;
• availability of services – such as investment advice or brokerage services – under each option;
Client Alert

- whether 401(k) plan participants have a greater ability to withdraw funds without penalty or to borrow funds;
- whether there are greater protections from creditors available to 401(k) plan assets versus IRA assets;
- the fact that the required minimum distribution at age 70½ generally does not apply to 401(k) plan participants if they are still working; and
- any adverse tax consequences of rolling appreciated employer stock held in a plan to an IRA. For example, stock appreciation generally will be taxed as ordinary income upon distribution. On the other hand, there may be long-term advantages to liquidating that stock and rolling over the value to an IRA, where greater diversification is generally available.

FINRA’S CONCERNS

In the Notice, FINRA voices its full range of sales practice concerns with respect to rollover recommendations. These familiar issues are likely to appear in any consideration of these recommendations in examinations during the coming year:

- **Conflicts of Interest** – the economic incentives all favor brokers who recommend a rollover, versus those who tell a 401(k) holder to stay put. Similarly, an investment adviser stands to earn an asset-based fee if the investor rolls over his assets.

- **Suitability** – to the extent their recommendation involves securities, a broker-dealer and its registered representatives must have a reasonable basis to believe that the recommendation is suitable for the customer, taking into account the considerations listed above. If a firm provides educational information to 401(k) plan participants regarding their retirement choices, but prohibits recommendations, the Notice admonishes firms to make sure that their educational materials do not cross the line into recommendations, since that would trigger their suitability obligations.

- **Supervision** – a firm’s procedures should be designed to ensure, among other things, that brokers perform customer-specific suitability analyses, and that marketing materials are fair and balanced.

- **Training** – a firm’s representatives who recommend rollovers should be trained concerning retirement savings options, and the relevant considerations in rollover decisions.

- **Communications** – marketing materials or oral statements must be fair and balanced, and cannot imply that a retiree’s only sound choice is to roll over retirement plan assets to an IRA. Moreover, communications cannot misrepresent the fees or expenses associated with a rollover, and must fairly compare the benefits of an IRA to those of other options.
Based on the content – and timing – of FINRA’s Regulatory Notice, it is fair to predict that examiners will review this area by looking at the following:

- **IRAs opened through transfer of funds from 401(k) plans:** once FINRA examiners identify those transactions, they are likely to apply this analysis to a sample of those transactions:
  - Was the transfer suitable from a tax, expense and investment objective standpoint, among other things?
  - What representations were made by the registered representative to the customer to induce the transfer?

- **Marketing materials:** Are they fair and balanced with respect to the fees and expenses attributable to transfers, and do they provide advantages of all the options available to a retiree?

- **Written supervisory procedures:**
  - Do they provide for review of new IRAs and transfers of funds into IRAs with the relevant considerations in mind?
  - Do they identify conflicts of interest inherent in rollover recommendations, and provide for heightened supervision to mitigate those conflicts?
  - Are the firm’s brokers trained as to the considerations relevant to rollovers?

**RECOMMENDATION**

As with any other “priority” issue identified by FINRA, we recommend that firms review their transactions, communications, and procedures to determine whether there are any issues that need to be addressed before FINRA discovers them.

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Coming Soon: Regulations for Uniform Fiduciary Standard

By Jay Baris on March 27, 2015

In testimony before the House Committee on Financial Services on March 24, 2015, SEC Chair Mary Jo White said that she supports a uniform fiduciary standard of conduct for broker-dealers and investment advisers that provide personalized securities advice to retail customers. She detailed plans for rules concerning enhanced risk monitoring and regulatory safeguards for asset managers.

Uniform fiduciary standard

White testified that she asked the SEC staff to develop rulemaking recommendations for the SEC to consider, taking into account the SEC staff recommendations contained in a 2011 report to Congress on this issue, and the views of other interested persons. She cited three challenges that the SEC faces in adopting rules:

- How to define the standard. White said she favors a principles-based approach rooted in fiduciary duty applicable to investment advisers.
- How to provide clear guidance on what the standard would require. This guidance would address how current business practices can or cannot continue under the new standard.
- How to provide meaningful application, examination and consistent enforcement of a new uniform standard. Central to this challenge, she explained, is extending examination coverage for registered advisers.

The basis of the regulatory initiative is Section 913 of the Dodd-Frank Act Wall Street Reform and Consumer Protection of 2010, which granted the SEC authority to impose a uniform standard of conduct for broker-dealers and investments that provide personalized investment advice. Section 913 required the SEC to report to Congress on its recommendations, which the SEC submitted in 2011.

Risk monitoring and regulatory standards

Separately, White said that under the authority of Section 965 of the Dodd-Frank Act, the Division of Investment Management established a new risk and examinations office (REO). She said that REO is developing recommendations for the SEC to “modernize and enhance data reporting for both funds and advisers.” Among other things, the initiative would:

- Update the reporting of basic fund census information;
- Enhance reporting of fund investments in derivatives, liquidity valuation of holdings and securities lending practices; and
- Collect more information on separately managed accounts.
White said that the Division of Investment Management is also considering whether the SEC should require enhanced risk management programs for mutual funds and exchange traded funds (ETFs), to address risks related to liquidity and use of derivatives, and to enhance the SEC’s oversight of these activities. In particular, she said that the Division is reviewing options for:

- Updated liquidity standards;
- Disclosure of liquidity risks;
- Measures to limit leverage through use of derivatives;
- “Transition plans” to prepare for the winding down investment advisers’ businesses; and
- Annual requirements for stress testing by investment advisers and funds.

Other issues

White also addressed other issues on the SEC’s agenda, including issuer disclosure and capital formation; trading and markets; economic analysis, risk assessment and data analytics; and enforcement. See MoFo’s Thinking Capital Markets blog concerning “Chair White’s Testimony on SEC Initiatives,” available here.
The Administration Proposes Imposing a Fiduciary Standard on Retirement Advisers

By Daniel Nathan and Kelley Howes on February 24, 2015

Yesterday, the Obama administration called on the Department of Labor to draft rules that, in effect, would require brokers who provide retirement advice to abide by a fiduciary standard. In a speech at an event hosted by the AARP, President Obama said that existing ERISA rules were written 40 years ago and are in need of updating. While the President did not use the word “fiduciary” once in his speech, he did say that the proposed rules would require retirement advisers to put the best interests of clients above their own financial interests.

The President emphasized that many financial advisers seek to do the right thing for their clients, but he criticized financial advisors who receive hidden fees for steering customers into “bad retirement investments that have high fees and low returns,” or who persuade investors to roll their existing savings out of a low-fee plan into a high-cost plan. The President emphasized that, under any new rules, financial advisors would still be fairly compensated, but that the proposal would level the playing field for “outstanding advisors out there so that they can... put... their clients first.”

At the same event, CFPB Director Richard Cordray emphasized the importance of the retirement savings market, which he stated can be “complicated and confusing.”

The Department of Labor’s proposal was previewed on Sunday by Secretary of Labor Tom Perez, and various constituent groups promptly began to voice reasons for and against the initiative. One significant objection is that the rules might not be coordinated with existing regulations adopted by the SEC, which regulates both investment advisers and broker-dealers. Section 913 of the Dodd-Frank Act mandated that the SEC study the standard of care applicable to investment advisers and broker-dealers and granted the SEC the authority to impose a uniform standard of conduct. The SEC staff undertook such a study and has continued to gather and analyze data related to the efficacy of the current standards of care. In testimony before the Senate Banking Committee last fall, however, SEC Chairperson Mary Jo White noted that a uniform fiduciary standard was not mandated by the Dodd-Frank Act. The SEC has apparently not yet made a decision on whether, and how, to move forward with a uniform fiduciary standard rule for brokers and advisers.

Another objection is that the proposed rules could increase costs to investors. President Obama, on the other hand, cited a study that showed that conflicts of interest in providing retirement advice results in losses to affected investors of 1 percent each year.

The President acknowledged the significant opposition to the proposed rules. He signaled that his administration would be open to discussion about the rules, stating, “that’s what the comment period for the rule is all about.”
Securities Regulators Are Inspired by an Academic Article to Seek Information Regarding Order Routing

By Daniel Nathan on April 28, 2014

Apparently attempting to understand how broker-dealers provide best execution in the face of incentives to trade at certain exchanges, the SEC and FINRA are asking broker-dealers for extensive transaction information regarding how they route trades to exchanges. By collecting this data, the regulators can monitor how firms, that have an incentive to trade with the exchanges offering the highest rebates, handle potential conflicts of interest with customers, who seek best execution.

The regulators’ requests appear to grow out of an academic paper recently published by several academics at the Indiana University and University of Notre Dame business schools.

The authors of the paper point out that every U.S. stock exchange today either charges fees or pays rebates on orders based, in part, on whether they are market orders (and the exchanges earn revenue on the difference between the fees and the rebates). Exchanges charge fees on market orders that take liquidity out of the marketplace and pay rebates on limit orders that supply liquidity to the market. The paper concludes that brokers might route customer limit orders to the exchange that pays them the highest rebates, but that do not necessarily provide best execution on their trades.

According to an article in the IU Bloomington Newsroom, the authors presented their paper to several broker-dealers and the SEC and FINRA, and the paper leaked out to the broader industry. FINRA apparently viewed the paper’s revelations as significant, since it sent out a broad request to much of the industry – for routing data from 50 firms, according to the article. It’s not clear whether FINRA is calling this a “sweep”; FINRA typically posts on its website its “Targeted Examination Letters,” except when it doesn’t; this is one of the “doesn’ts.”

Now we have learned that the SEC is making similar requests, using its inspection powers under Section 17(a) of the Exchange Act and issuing subpoenas. Larger firms should anticipate that one or both of the securities regulators will be seeking their data, and we suggest that those firms that receive these invitations to provide data remain cognizant that there are many firms that were invited to the same party. Many of these firms have discussed these requests with the regulators, and there are opportunities for seeking clarifications and further information from other firms or their counsel.

We cannot predict where the regulators will take this inquiry, but firms drawn into it will only benefit from having as much information as possible.