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# AML Independent Test: Tips for Engaging a Qualified Provider

By Laura H. Goldzung, CAMS, CFE, CFCS, CCRP

Like most things in business, it's best to conduct a little research before engaging a third party to provide needed services, and this couldn't be more true when engaging a consultant to conduct your annual AML independent test. This wisdom comes in handy particularly after regulators have scrutinized institutions' not having a full understanding of regulatory expectations. After countless disciplinary actions in a variety of sectors including those within the FINRA regulatory scheme, I offer the following insights.

**What should a firm know?**

Most important to financial institutions is their third party provider's underlying knowledge of the institution's business model and their knowledge of what the regulators expect in terms of scope, plan, and testing. There are all kinds of providers who claim that they can conduct your test. Some independent consultants are former law enforcement agents or ex-regulatory examiners and staff, and others are from the big accountancy and consultancy firms, CPAs or industry professionals striking out on their own. Just because they come from related backgrounds doesn't mean they have the knowledge of AML to do the best job possible.

**Comparing Apples With Apples**

From the small consultancy to the big name companies that we all know from their abundant exhibits at conferences, comparison shopping will benefit you in the long run. Obtain a few proposals, not just quotes. You may get a low quote for a less than optimal scope. There is a plethora of providers to choose from. Ask some of your networking friends or others in your institution if they know of anyone. Take a look at LinkedIn. Perform a Google search using a simple phrase like broker-dealer AML or AML independent test for broker-dealers.

**Don't Sacrifice Certified Professionals to Save Money**

It's no surprise that BDs are accustomed to a transactional mindset, but don't apply this to an engagement for the AML test. If you simply go for the lowest quote, you will get only what you pay for. AML testing requires a comprehensive knowledge of Bank Secrecy Act, USA PATRIOT Act and OFAC laws and regulatory requirements, as well as the skills to scope, plan and conduct transaction testing, and to write a comprehensive report of findings while providing a set of work papers, as required by virtually all regulators upon request. The work papers are made available to the regulator, however, the report is made available to the Board of Directors/senior management and sometimes the banking relationship, state examiners, and partners, i.e. clearing firm, upon request.

**Know Your Regulator!**

Just as you apply KYC to your customer base, you should know FINRA and what their expectations are as to "adequate" AML testing. Like other regulators, FINRA makes no secret of the fact that it has certain expectations about the comprehensiveness of the AML testing. In fact, a recent disciplinary action[1] was brought against BBH and its AML Compliance Officer, which included failure to conduct adequate AML testing.[2] It is incumbent on the firm to know what adequate testing consists of in the context of the engagement and the scope should be spelled out very clearly in the engagement letter.

**Be Aware of Time Required**

It makes sense that independent AML testing for a small broker-dealer will take less time than for a large complex firm. But take notice that just because you may be on a biennial schedule, for those BDs in the M&A space, for example, your independent audit doesn't necessarily take less time than will a firm on the annual schedule. For the M&A-Private Placement types, there is testing that will entail reviewing client agreements, third party agreements and other differences. Many small firms who seek providers will automatically think that because they are small it equates to less time. Remember that only 20% or so of FINRA members are large firms. Most are small firms, and many are micro firms. Thorough is thorough, and all the steps must be taken to ensure your AML program is compliant and adequate.

**Understand the Service Offered**

Make sure you understand what is being offered in their standard program. Hiring a third party to conduct your test is like hiring a business partner, not an "examiner." Many firms initially think of the AML third party provider as they would a regulator coming in. AML consultants are advisory in the context of conducting the independent test, not adversarial. They are there to assist and educate you, not only about the testing process, but the regulatory process, the AML laws and how they apply to your business model and other value-added benefits in the relationship context.

**ABOUT THE AUTHOR**

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1 Brown Brothers Harriman & Company http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p443448.pdf

2 Failure to Conduct Adequate AML Testing: FINRA found that, during the Relevant Period, the Firm failed to conduct adequate AML testing. FINRA Rule 3310(c) requires member firms to arrange independent testing for compliance with its AML program. Although the Firm conducted such tests, FINRA found that the tests failed to address the primary risks associated with the Firm's brokerage business involving penny stocks, including the identification of any of the shortcomings in the trade monitoring and asset movement monitoring related to penny stocks. FINRA also found that, during certain years of the Relevant Period, the tests failed to address penny stock activity despite such activity involving high-risk transactions for the Firm's customers.

Make sure you understand what is being offered in their standard program. A reputable company will include the following:

- **Engagement Proposal containing the following elements:**
  - Audit Plan & Objectives
  - Scope of Work including what will be tested
  - Review Period for Testing
  - Methodology
  - Deliverables with time frames
  - Professional Fees including retainer payment and time frames for payment
  - Number of persons conducting the test
  - Terms of Engagement including confidentiality of data and documents collected, disclosures, invoicing, etc.
  - Biographies of professional(s) conducting the audit
  - Signatures

- **The Independent Testing Service should include:**
  - Conducting initial discovery about the firm, its business model, AML compliance officer and program elements
  - Review of Documents (Request List) and statistics about the firm
  - Onsite visit to your offices
  - Conduct entrance meeting with Compliance Officer and key stakeholders
  - Conduct interviews with key personnel
  - Compliance process walk-throughs including technology tools used in AML program, manual or automated transaction monitoring, dispositioning of alerts, documentation of changes to automated monitoring and tuning
  - AML policies, procedures and controls review, testing policies against procedures
  - Risk assessment or methodology – test for reasonableness
  - CIP & risk-based verification sampling/testing
  - CDD/KYC review and sampling/testing
  - EDD at onboarding and ongoing for higher risk customers
  - AML Training including review of content for comprehensiveness of training, and how tracking and recordkeeping is managed
  - Information Sharing: Section 314(a) process review and testing; voluntary participation in Section 314(b) and provisions for confidentiality
  - Independent Testing – comprehensiveness of previous test, findings or recommendations, and testing of corrective actions from past reviews and sustainability of corrective controls
  - Corrective actions from previous regulatory (FINRA/SEC/State) examinations and sustainability of corrective controls
  - Reliance with other third party providers/vendors (know your vendors)
  - Records of Funds Transfers under the joint and travel rules
  - Suspicious activity monitoring (system as a whole), red flags and escalation, investigations and case management
  - Suspicious activity reports sampling/testing for accuracy, narrative, and timely filing
  - OFAC sanctions compliance including screening tools used, monitoring, training, and processes for rejecting/blocking, reporting and recordkeeping, customer and employee batch screening provisions, sampling/testing
  - Other BSA reports where applicable – FBAR, CTR, CMIR, sampling/testing
  - Law Enforcement Requests tracking, confidentiality, and resolution of requests
  - Recordkeeping, record retention and accessibility of records
  - Business continuity with respect to recordkeeping
  - Exit Meeting with AML stakeholders

- **Deliverables will include:**
  - Comprehensive Report identifying scope, review, testing, analysis, requirement, observation and recommendation for enhancement, or deficiency or violation and requirement to bring into compliance
  - Overall statement of condition of AML Compliance Program, i.e. adequate
  - Risk-based action plan to resolve recommendations or deficiencies
  - Work papers with all documents referenced and containing objectives and rationale for analyses and testing, and outcomes

**Be wary if a company guarantees you a problem-free result**

There's a lesson in this statement. That old adage, "If it looks too good to be true, it probably is" applies in AML too. The purpose of the AML test is to ensure conformity with the laws and regulations and to ascertain the adequacy of the program controls. A reputable provider will not guarantee anything, least of all that it can provide a report that is sure to win over a regulator. Nor are third party providers "endorsed by FINRA." In the post-incident scenario where FINRA requires a firm to engage an independent consultant to conduct certain tasks, FINRA may find a third party provider to be "not-objectionable," clearing the way for selection by the firm.

**Conduct Due Diligence**

Conducting due diligence is important when hiring a qualified and experienced AML professional to conduct your independent test. Not all AML professionals are created equal. An AML consultancy may be great at developing policies and procedures and even delivering custom training and performing due diligence, but this doesn't necessarily mean they are skilled in delivering the audit and test. I know of one institution that was disappointed with their audit report because they learned after the fact that the consultants had never audited a firm, and had only performed other services. The result was a 225-page report! The lesson here is to ask the right questions, such as:

- Have you conducted independent test for a broker-dealer? Do your professionals have testing experience with FINRA firms? Are they qualified or even certified?

- Do you provide an engagement letter spelling out the plan, scope, what will be tested and timing for the report delivery?

- What is your process for conducting the test? What information do you need before providing a written proposal?

- What is your scheduling? How long does it take from start to finish?

- Do you offer multiple year agreements with reduced pricing?

- Ask for references! While most consultancies cannot publicize the names of clients, most will have a list of a few willing references. ✦

# SEC Amends Financial Responsibility Rules, Customer Asset Protection, the Early Notification Rule and the Books and Records Rules for Broker-Dealers

By Paul B. Uhlenhop and John D. Ruark [1]

On October 17, 2013, the SEC Extended the Effective Date for a Number of the Rules in the Following Article.

On October 17, 2013, the SEC entered an order providing BDs a temporary exemption from the effective date of October 21, 2013 to March 3, 2014 for most of the amendments and position statements that are discussed in the following article.[1] The article was in the process of being published when the SEC's Release was published. The SEC did not extend the effective dates for all of the amendments, all of which were to be effective October 21, 2013. The SEC is not granting a temporary exemption from all amendments and changes adopted in Release No. 70072, on July 30, 2013, in particular:

(1) The requirement in paragraph (j)(1) of Rule 15c3-3; (2) the new requirements in Rule 15c3-1 (other than the requirement in paragraph (c)(2)(iv)(E)(2) of Rule 15c3-1); (3) and the new requirements in Rule 17a-11.

The SEC extended the effective date because of the significant amount of changes, including significant operational and system changes necessary to comply with the final rule amendments. The temporary exemption will sunset on March 3, 2014. The SEC hopes that this will facilitate an orderly transition to the new requirements by providing BDs with time to make the necessary operational and system changes.

**I. Introduction**

During the last five years, the securities and futures industry has been rocked by highly publicized insolvencies of several major broker-dealers and futures commission merchants. These events have highlighted deficiencies in the customer asset protection schemes of both the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). On July 31, 2013, in two separate 300 page rule making releases,[2] the SEC announced the adoption of amendments to its:

1. broker-dealer ("BD") customer asset protection scheme and related rules (the "Adopting Release"), effective October 21, 2013; and

2. financial reporting scheme for BDs, enhanced auditing requirements, form custody, the new Compliance Report and the new Exemption Report (the "Reports Adopting Release") (various effective dates between December 1, 2013 and June 15, 2014).

**ABOUT THE AUTHORS**

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The Adopting Release is based upon a 2007 rule proposal referred to in this article as the "Proposing Release".[3] The Reports Adopting Release is based on a 2011 rule proposal referred to as the "Reports Proposing Release".[4] In addition to new rules, both Releases also codified a number of staff interpretations and clarified certain rules which, in some cases, revised interpretations and added additional conditions and/or exceptions to prior interpretations.

This article will discuss the (i) revisions to customer asset protection rules, including the codification of the protection of assets of an introducing broker-dealer ("IBD") carried at a broker-dealer clearing firm ("CBD"), (ii) amendments to the financial responsibility rules (Rules 15c3-1, 15c3-2 and 15c3-3), (iii) revisions to the books and records rules (Rules 17a-3 and 17a-4), and (iv) revisions to the early notification rule (Rule 17a-11).[5] A second article, appearing in an upcoming issue of *Practical Compliance and Risk Management for the Security Industry*, will focus on the Reports Adopting Release.

**II. Proprietary Accounts of Broker Dealers; 15c3-3 Changes**

A. Broker-Dealer Proprietary Account Asset Protection Scheme Rule Changes

Rule 15c3-3[6] has been amended to codify and clarify that proprietary assets of an IBD (both foreign and domestic) carried at a CBD will be treated similarly to customer assets in the event of insolvency of the CBD. As a result of the amendments to the rule, IBD assets held or carried at a CBD will be covered by the Rule 15c3-3 IBD protection scheme unless the IBD subordinates any claims to the creditors of the CBD.[7] This IBD asset protection scheme lessens the possibility of a shortfall of assets owed to IBDs in the event of a CBD insolvency. Since any such shortfall would also have led to a shortfall of customer assets which SIPA would have been required to cover, this is a worthwhile change.

To understand the SEC rule changes, it is necessary to understand Rule 15c3-3 and how it protects customer assets. Rule 15c3-3 was adopted in 1972 "in response to Congressional directive to improve financial responsibility of broker-dealers that carry customer assets."[8] The purpose of the rule is to enable prompt return of funds and securities to customers in the event of a CBD insolvency.[9] Rule 15c3-3 is complex, but in essence requires CBDs carrying customer assets to segregate the net amount due customers in a "Reserve Account" and to maintain, in "control locations," fully paid excess margin securities held by the CBD for customers.

The required amount of customer funds to be segregated for customers (the "Reserve Calculation") is calculated pursuant to a formula set forth in Exhibit A to the Rule. The SEC in the Proposing Release explained the process as follows:

*Under the formula, the broker-dealer adds up various credit and debit line items. The credit items include cash balances in customer accounts and funds obtained through the use of customer securities. The debit items include money owed by customers (e.g., from margin* *lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions. If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash or qualified securities in that net amount in a 'Special Reserve Bank Account for the Exclusive Benefit of Customers.' This account must be segregated from any other bank account of the broker-dealer.[10] (Emphasis added.)*

With respect to customer securities:

*…Rule 15c3-3 also requires a broker-dealer to maintain physical possession or control of all fully paid and excess margin securities carried for customers. As a result, the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location.[11] If a shortfall exists, the broker-dealer must remove liens on securities collateralizing a bank loan; recall securities loaned to a bank or clearing corporation; buy-in securities that have been failed to receive over thirty days; or buy-in securities receivable as a result of dividends, stock splits or similar distributions that are outstanding over forty-five days. (Citations omitted).[12]*

Reserve calculations must be made weekly as of the close of the last day of business of the week. Deposits of cash and/or qualified securities sufficient to maintain the formula net credit amount must be made no later than one hour after the opening of banking business on the second following business day.[13] However, a small BD which has an aggregate indebtedness not in excess of 800% of net capital and which carries aggregate customer funds as computed at the last computation not exceeding $1 million may, in the alternative, make the customer reserve calculations monthly as of the close of the last business day of the month. Any IBD using this alternative method must deposit in the reserve account not less than 105% of the reserve calculation amount no later than one hour after opening of banking business on the following business day.[14]

B. Why the Change Was Necessary – the SIPA Coverage Anomaly.

The Securities Investors Protection Act of 1970 ("SIPA")[15] does not provide SIPC insurance with respect to proprietary accounts of IBDs. SIPA provides customers up to $500,000 insurance coverage (of which no more than $100,000 may be in cash) in the event of a shortfall in customer assets. Under Rule 15c3-3's definitions, the term "customer" specifically does not include a BD.[16] As a result, there is no reserve or segregated fund for IBDs in the event of the insolvency of a CBD. However, under SIPA, IBDs that maintain proprietary accounts at a CBD are entitled to share pro rata in the customer assets of the CBD (including the reserve account, securities and other customer assets[17]) potentially leading to a shortfall of readily available funds and securities for customers in the event of insolvency. In a worst case, a shortfall of assets for the IBDs could result in some IBDs not having enough capital to continue in business, which could lead to a chain reaction of BD insolvencies. In addition, since customers' assets would be part of the customer asset pool, if BDs participate in the pool pro rata, this also decreases the amount available for customers, thereby increasing the amount SIPC must cover.[18] In order to lessen the possibility of a shortfall, the SEC staff developed a regime, by interpretation and no-action letter, regarding how to address Proprietary Accounts of Introducing Brokers ("PAIB").

C. The PAIB Regime

To partially fill this gap between Rule 15c3-3 and the insolvency treatment under SIPA, in 1998, SEC staff issued a no-action letter[19] providing that assets in a proprietary account of an IBD at a CBD were not good assets of the IBD for net capital purposes under Rule 15c3-1 unless the proprietary assets of an IBD at a CBD were held pursuant to an agreement between the CBD and the IBD under which the CBD agrees to:

1. Maintain at an unaffiliated bank a PAIB Reserve Account pursuant to an agreement with the bank that the funds and securities in the reserve account are the property of IBDs, not the property of the CBD or the bank.
2. Make weekly computations pursuant to the reserve formula and deposit the amount of free credit balance from the PAIB reserve computation in the PAIB bank account in cash or qualified securities.
3. In the case of securities, hold them in appropriate control locations so that they are readily available to a trustee in the event of liquidation.

The PAIB scheme developed by the SEC staff seems to have worked smoothly to date, but there was concern that, as a staff interpretation implemented by contract, it may be questioned in an insolvency proceeding. The recent amendment to Rule 15c3-3 adopted by the SEC codifies and expands the SEC staff's PAIB letter scheme.

D. The PAB Rule Codification.

New paragraph (a)(16) of Rule 15c3-3 defines a Proprietary Account of Broker-Dealers ("PAB") account as follows:

*(16) The term PAB account means a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account. The term does not include an account that has been subordinated to the claims of creditors of the carrying broker or dealer.[20] (Emphasis added.)*

Rule 15c3-1 (the Capital Rule) has been amended to provide that an IBD need not deduct from capital under Rule 15c3-1 the amount held in its proprietary account at a CBD provided the carrying arrangement between the CBD and the IBD meets the requirements of amended Rule 15c3-3,[21] which provide, among other things, the following.

1. Establishing a special PAB reserve bank account at an unaffiliated bank with specific requirements including an agreement with the bank that the assets held in the PAB account are property of the IBD and not the property of the CBD nor the bank at which the PAB account is held.
2. Performing a weekly (monthly for small BDs) PAB reserve computation for assets carried in IBD proprietary accounts.
3. Maintaining cash or qualified securities in the PAB reserve account equal to the computed reserve requirement (i.e., the net credit balance to due to the IBDs).[22]

Paragraph (g) of Rule 15c3-3 provides that the CBD can make withdrawals from the PAB reserve account, but only in accordance with the rule, similar to the current customer reserve account withdrawal provisions. The new PAB amendments also permit the CBD to use PAB credits to finance "customer" debits but prohibits the use of credits in the customer reserve account to finance debits in the PAB reserve account.[23]

The new PAB scheme, like the PAIB scheme, requires the CBD to make a computation weekly of the credits (owed to IBD) and debits (owed to CBD) pursuant to the reserve formula of Appendix

A to Rule 15c3-3.[24] The net of the credits and debits is the amount of the PAB reserve that must be maintained in cash or qualified securities in a separate segregated account at an unaffiliated bank. Under the PAB regime (like the PAIB regime), the CBD must make a computation weekly (or monthly for small BDs) and deposit within 2 business days of the weekly computation the net amount owed to IBDs by the CBD in cash or qualified securities in the PAB reserve account.[25] As with the customer reserve formula net amount, the PAB reserve account net amount must be maintained at a non-affiliated bank. The CBD must have an agreement with the bank acknowledging that the PAB account is for the exclusive benefit of the IBDs and is kept separate from any other account of the CBD maintained at the bank and confirming that the bank may not have any direct or indirect lien, security interest or otherwise use the account to secure obligations of the CBD to the bank or any other party claiming through the bank.[26]

Under the amended Rule 15c3-3(b)(5), the CBD is not required to maintain physical possession or control of non-margin securities carried for a PAB account provided that the CBD provides adequate written notice to the account holder that the CBD may use the securities in the CBD's ordinary business.[27] In the event that the IBD does not object, the CBD may use the IBD's securities in its business but the CBD will need to include the market value of the securities as a credit in the reserve formula when performing the PAB reserve computation. It should be noted that there is no debit to offset this credit, so it will in effect require the CBD to fund the PAB reserve account. It should also be noted that securities not being used by the CBD must be maintained in accordance with the possession and control requirements of Rule 15c3-3.

E. <u>Exclusions From Definition of PAB Account</u>.

An IBD's account is excluded from the definition of PAB account if the introduced account has been subordinated by agreement to the claims of creditors of the CBD. Likewise, the definition of PAB account also excludes a delivery-versus-payment ("DVP") account or receipt-versus-payment ("RVP") account. [28]

F. <u>Foreign Broker-Dealers and Banks Acting as Broker-Dealers</u>.

Under the changes to Rules 15c3-1, 15c3-2 and 15c3-3(a), CBDs carrying proprietary accounts of foreign BDs, including foreign banks that are operating as BDs, are required to include such proprietary accounts in the CBD's PAB reserve computation. As noted above, however, the definition of PAB account does not include any IBD account that has been subordinated by agreement to the claims of creditors. [29]

G. <u>Banks Where Special Reserve Accounts May Be Held</u>.

Amended Rule 15c3-3(e)(5) will make it difficult to maintain a reserve account at a bank affiliate of the CBD since cash held in a reserve account held at an affiliated bank may not be counted in determining the required minimum PAB reserve funds deposit. The exclusion does not apply to deposits of securities (as opposed to cash) in a segregated reserve account at an affiliated bank of a CBD. With respect to <u>unaffiliated</u> banks, a CBD is required to exclude from its net capital amounts deposited to the extent the balance of the account exceeds (i) 50% of the BD's excess net capital based on its most recent FOCUS report; or (ii) 15% of the bank's equity based on the bank's most recent financial reports.[30]

H. <u>SEC Declined to Expand the Definition of "Qualified Securities" for a Reserve Account to Include Certain Money Market Funds</u>.

Rule 15c3-3(a)(6)'s definition of "qualified securities" specifies the securities (essentially limited to U.S. government securities) that may be held in the reserve account or PAB account in lieu of cash. The SEC had originally proposed that "qualified securities" also include certain "Government Securities" money market mutual funds. The SEC did not adopt the proposed expansion of "qualified securities" for 15c3-3 reserve accounts because of its ongoing study with respect to money market funds.[31]

I. <u>Aggregate Debit Item Charge</u>.

Note E(3) to the reserve formula of SEC Rule 15c3-3a requires that BDs using the <u>basic method</u> of computing net capital under Rule 15c3-1 reduce total debits by 1% of item 10 (customer debit balances) of the reserve formula. However, for BDs using the <u>alternative standard</u> to compute its minimum net capital requirements, aggregate debit items are required to be reduced by 3% in lieu of the 1% otherwise required by Note E(3). The SEC decided not to revise this charge to 1% (in lieu of the 3%) of aggregate debit items for BDs using the alternative standard to compute capital.[32]

**III. <u>Allocation of Customer Fully Paid and Excess Margin of Securities to Short Positions</u>**

Rule 15c3-3 was amended to require that a BD retrieve from any non-control location, within thirty business days of settlement, securities of the same issue and class of those included on the BD's books as a proprietary short position or a short position for another person. Previously, this time period was ten business days, with the thirty-day time frame applied only to market makers. The rule change makes the time frame uniform – thirty business days regardless of whether the person is a market maker.[33]

**IV. <u>Treatment of Free Credit Balances and Sweep Programs</u>**

New subsection (j)(1) of Rule 15c3-3 makes it unlawful for a BD to convert, invest or otherwise transfer to another account or institution, free credit balances held in a customer's account except as provided in subsection (j)(2). Subsection (j)(2) provides that a BD is permitted to convert, invest or otherwise transfer to another account or institution free credit balances in a customer's account on the customer's specific order, authorization or draft <u>but only</u> in the manner and terms and conditions specified in the order, authorization or draft.[34] New paragraph subsection (j)(2)(ii) provides that a BD is permitted to transfer free credit balances held in a new account of a customer to a product in its Sweep Program or to transfer the customer's interest in one product in a Sweep Program to another in a Sweep Program subject to the conditions discussed below.

Commentators mentioned that Rule 15c3-3(j)[35] proposed revisions did not clearly cover mass transfers. Therefore, the SEC revised paragraph (j), and now paragraph (j)(2)(ii) clarifies that the conditions for operating a Sweep Program will apply to (1) the transfer of free credit balances from a customer's securities account to a product in a Sweep Program and (2) the transfer of customers' interest in one Sweep Program to another Sweep Program. These provisions will also cover bulk transfers of customer positions from one product – for example a money market fund – to another bank deposit product and transfers of individual positions from one product to another.

The Adopting Release described the new amendments as follows:

*As adopted, paragraphs (j)(2)(ii)(A) and (B) establish four conditions that must be met … to transfer a customer's interest directly from one product in a Sweep program to another product in a Sweep Program….[P]aragraph (j)(2)(ii)(A) – applies only with respect to accounts opened on or after the effective date of the rule….[36]The remaining three conditions – set forth in paragraph (j)(2)(ii)(B)(<u>1</u>) through (<u>3</u>) – apply to both existing and new accounts.*

*Paragraph (j)(2)(ii)(A), as adopted, provides that for an account opened on or after the effective date of the rule, the customer must give prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified: (1) of the general terms and conditions of the products available through the Sweep Program; and (2) that the broker or dealer may change the products available under the Sweep Program.[37] (Emphasis added.)*

The Commission has modified paragraph (j)(2)(ii)(A) in the final rule to read 'the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified….'[38] The Commission modified this paragraph to incorporate the term Sweep Program as defined in paragraph (a)(17) of the rule and the reference to the 'customer's securities account' to make this paragraph consistent with other modifications to paragraph (j)(2) of the final rule. Additionally, the Commission modified this paragraph to clarify that the customer's consent must be written, consistent with the discussion in the proposing release, which noted customer consent could be given in an account opening agreement.[39] As noted above, subsection (j)(2)(ii)(A) applies only to accounts opened after the effective date (October 20, 2013).

Paragraph (j)(2)(ii)(B), as adopted, prescribes the following conditions to sweeping customer free credit balances in all accounts (new or existing):

(1) The broker-dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each SRO of which the broker-dealer is a member;

(2) The broker-dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and

(3)(i) The broker-dealer provides the customer with written notice at least 30 calendar days before:

(A) making changes to the terms and conditions of the Sweep Program;

(B) making changes to the terms and conditions of a product currently available through the Sweep Program;

(C) changing, adding or deleting products available through the Sweep Program; or

(D) changing the customer's investment through the Sweep Program from one product to another;

(ii) the notice describes the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.[40] (Emphasis added.)

These amendments present a number of issues for BDs. The SEC staff (as well as the SROs) have, under the general anti-fraud and fair dealing provisions, advised BDs to give customers adequate disclosure and notice. Firms should review their procedures to confirm on-going disclosures are made with respect to money market mutual funds or other Sweep Programs. While many customer agreements include provisions similar to those required, firms would be well advised to review customer agreements and amend as necessary.

Importantly, the SEC recognized in the Adopting Release that there may be instances where an unusual emergency requires a waiver of the thirty day written notice. In such cases the Adopting Release states:

*"A broker-dealer could request exemptive relief from the Rule in unusual or emergency cases where it may be impractical or contrary to investor protection for a broker-dealer to first provide customers thirty days written notice under the rule before taking one of these actions."[41]*

**V. Incorporation of Rule 15c3-2 into Rule 15c3-3(j)(1)**

The SEC eliminated Rule 15c3-2, incorporating its substance into SEC Rule 15c3-3(j). Rule 15c3-3(j), as amended, will require that BDs inform each customer at least quarterly of the amount of free credit balance due the customer and that such amount is payable upon demand. Most BDs already show free credit balances, if any, in their monthly or quarterly customer account statements with the required statement that free credit balances are payable on demand. As such, Rule 15c3-2 was redundant.

**VI. Certain Accounts Under the Commodities Exchange Act**

The SEC amended paragraphs (a)(8) and (9) of Rule 15c3-3 to clarify its position that funds held in a customer commodity futures account of a BD that is also a futures commission merchant ("FCM") are not to be included in "free credit balances" or "other credit balances"[42] if the funds are segregated in accordance with the Commodity Exchange Act, as amended ("CEA") or in a similar manner.[43] Likewise, funds held in a "proprietary"[44] commodity futures account are not to be included in "free credit balances" or "other credit balances" whether or not segregated.[45] Under the CEA and CFTC rules, customer funds and securities held at a FCM must be segregated and carried in a segregated account at a bank.[46] This amendment is a helpful clarification, as the SEC and SRO interpretations on this subject were not particularly clear, creating unnecessary uncertainty.

**VII. Futures Positions in Securities Portfolio Margin Accounts**

Under the SRO portfolio margin rules, a BD may combine securities and futures positions in a portfolio securities account to compute margin requirements based on the net of all positions in the account. The Dodd-Frank Act[47] amended and expanded the SIPA insurance for customer claims to cover futures contracts held in a customer portfolio margin account at a BD. The SEC amended Rule 15c3-3 in light of the fact that futures positions in a portfolio margin account would be covered by SIPA in a SIPA liquidation. To facilitate the securities and futures portfolio margining, the SEC proposed several amendments. After reviewing the comments the SEC adopted the following changes:

*…the text in paragraphs (a)(8) and (a)(9) of Rule 15c3-3 expands the terms free credit balance and other credit balances to include 'funds carried in a securities account pursuant to a self-regulatory organization portfolio margin rule approved by the Commission… including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.' The amendments, as adopted, more precisely capture the Commission's intent in terms of identifying the types of futures-related cash balances that may be held in a portfolio margin account than the language in the proposed rule.*

*On the debit side of the customer reserve formula, the Commission is adopting, substantially as proposed, an amendment to Rule 15c3-3a Item 14 that permits a broker-dealer to include as a debit item the amount of customer margin required and on deposit at a derivatives clearing organization related to futures positions carried in a portfolio* *margin account. Under SIPA, the term* *customer property* *includes, 'resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by the Commission by rule,' as well as, 'in the case of a portfolio margining account of a customer that is carried as a securities account pursuant to a portfolio margining program approved by the Commission, a futures contract or an option on a futures contract received, acquired, or held by or for the account of a debtor from or for such portfolio margining account, and the proceeds thereof.' Under this provision of SIPA, this amendment to Rule 15c3-3 makes the margin required and on deposit at a derivatives clearing organization part of the 'customer property' in the event the broker-dealer is placed in a SIPA liquidation. Thus, it would be available for distribution to the failed firm's customers. (Emphasis in original.) (Citations omitted.)*[48]

The amendments to Rule 15c3-3 are designed to provide the same treatment to futures related cash balances in a portfolio account as it applies to securities related cash balances.[49]

**VIII. The Regulatory Oversight of Securities Lending and Repo Transactions**

Subparagraph (c)(2)(iv)(B) to Rule 15c3-1, as amended, provides that BDs lending and borrowing securities are presumed, for purposes of the rule, to be acting as principal and therefore subject to applicable capital deduction under the capital rule. However, these deductions do not come into play if the BD takes certain steps to disclaim principal liability by disclosing the identities of the borrower and lender to each other and obtaining agreements from each of the borrower and lender stating the BD is acting exclusively as agent and assumes no principal liability in connection with the transactions.[50] This is consistent with the Standard Master Securities Loan Agreement, including Annex I, commonly used by parties for securities borrowing and lending transactions, as it contains similar provisions for establishing agency as opposed to principal status.[51]

In addition, paragraph (c)(5) of Rule 17a-11[52] was amended to require monthly notification and reporting to the SEC, SROs, and other regulators whenever, if the BD is acting as a principal (1) the total amount payable against all loaned securities, (2) the total amount subject to repurchase agreements or (3) the total contract value of all securities borrowed subject to a reverse purchase agreement exceeds 2,500 percent of tentative net capital. However, transactions in government securities as defined under Section 3(a)(42) of the Securities Exchange Act[53] are excluded from the new leverage threshold.

Firms will have to set up specific procedures to review account documentation for each counterparty if the broker wishes to act as an agent, as opposed to a principal, in connection with the lending or borrowing of securities. Likewise, any BD engaged in securities lending will need to be certain that it is taking the applicable capital deduction unless it can demonstrate it is acting as an agent. With respect to the new thresholds under Rule 17a-11, the leverage thresholds will have to be built into a firm's procedures and controls to provide for such notification if the threshold is tripped. While not specified, it is likely the SEC will require continuous compliance with this rule at all times during the day, not just at the end of the day. Consequently, a firm should set thresholds and procedures so that any trades that would take it above the threshold level at any time during the day are rejected.

**IX. Documentation of Risk Management Procedures**

Paragraph (a)(23) to Rule 17a-3 was amended to require certain BDs to document and implement risk management controls designed to assess and manage risk arising from the business activities engaged in.[54] Risks include, but are not limited to, credit, liquidity and operational risks. This requirement will apply only to BDs that have (1) more than $1 million in aggregate credit items as computed under the customer reserve formula or (2) $20 million in total capital, including debt subordinated in accordance with Appendix D of Rule 15c3-1. Under Rule 17a-4, the holding period of such records would be for three years after the BD ceases to use a particular system of controls.[55]

**X. Requirement to Subtract Certain Liabilities and Expenses Assumed by Third Parties from Net Worth for Net Capital Purposes under the Net Capital Rule**

These changes essentially codify the SEC's staff positions and SRO interpretive positions that have been in place for some time. Rule 15c3-1 was amended to add a new paragraph (c)(2)(i)(F) that requires a BD to adjust its net worth when computing net capital by including any liabilities assumed by third parties if the BD cannot demonstrate that the third party has resources independent of the BD's income and assets to pay the liabilities.[56] This requires BDs to maintain records of affiliates or other third parties that assume obligations, including the detailed up-to-date financial statements from such parties. It has been the practice of the FINRA examiners in recent years to ask for this detailed financial information regarding any entity assuming the obligations of a BD. Consequently, most firms where this is a potential issue likely already have in place procedures with respect to the required records to show the ability of a third party assuming liabilities to make payment as required.

**XI. Non-Permanent Capital**

The SEC also amended paragraph (c)(2)(i)(G) of Rule 15c3-1 to require a BD to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it within one year or that is intended to be withdrawn within one year unless the BD first receives permission in writing from its designated examining authority (usually FINRA but potentially CBOE). This is a codification of the SEC staff position of many years. This requirement would not apply to withdrawals covered by paragraph (e)(4)(iii) of 15c3-1.[57] While this is not a new development, as a reminder, to avoid the dilemma of retroactive application, all contributions of capital should be structured so that they may not be withdrawn for a one year period of time absent regulatory permission.

**XII. Requirement to Deduct Amount of Fidelity Bond Limits as Set by Broker-Dealer's SRO**

The SEC proposed an amendment of Rule 15c3-1(c)(2) by adding a new subparagraph (c)(2)(xiv) that requires a BD to deduct the excess of any deductible amount of its fidelity bond requirement over the maximum deductible amount prescribed by the BD's SRO examining authority. The SEC changed the wording of the final rule to provide that the BD must deduct "the amount specified by the rule of the BD's examining authority with respect to a requirement to maintain the fidelity bond coverage."[58]

**XIII. Broker-Dealer Solvency Requirement**

The SEC amended Rule 15c3-1(a) to provide that a BD shall not continue to conduct business if the firm is "insolvent" as that term is defined in new paragraph (c)(16). "Insolvency", among other things, would include voluntary or involuntary bankruptcy or a similar proceeding by a trustee, receiver or similar official, a general assignment by the BD for the benefit of its creditors, an admission of insolvency or an inability to make a computation to establish compliance with Rule 15c3-1.[59] In other words, if the BD is "insolvent" within the meaning of paragraph (c)(16), it would have to immediately stop effecting any transactions or attempting to enter or induce the purchase or sale of any security. Further, the SEC also amended Rule 17a-11 to require that a BD meeting the definition of "insolvent" to provide immediate notice to the SEC, SIPC, appropriate SROs, and the CFTC, if applicable.

It should be noted that among the conditions that cause a BD to be deemed "insolvent" is the inability to make a capital computation. This may be problematic in certain situations. It will be interesting to see how the SEC treats this from a practical standpoint. For example, a BD could have substantial excess net capital but be unable to determine its exact net capital due to difficulty obtaining price data, international disruption or similar events. In the past, the SEC staff has allowed the BD to continue operations albeit with conditions.

**XIV. Amendments to the Capital Rule Governing Orders Restricting Withdrawal of Capital from a Broker-Dealer**

Currently, paragraph (e)(3)(i) of Rule 15c3-1 restricts a BD when it is withdrawing capital or making loans or advances to stockholders, insiders or affiliates under certain circumstances ("Withdrawals"). The BD must give the SEC notice of Withdrawals above certain moving thresholds. The SEC may issue a temporary order prohibiting Withdrawals above certain moving percentage triggers set forth in Rule 15c3-1(e). The SEC removed percentage triggers which were difficult to compute. The paragraph now provides that the SEC may restrict Withdrawals with no monetary limit for up to twenty business days.[60] In the final rule the SEC added the following additional language that the orders will be issued:

*…under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection act of 1970.*[61]

**XV. Adjusted Net Capital Requirements (Amendment to Appendix A of Rule 15c3-1)**

The SEC amended paragraph (b)(1)(iv) of Appendix A to Rule 15c3-1 to make permanent previously granted relief permitting a reduced range of pricing inputs to the theoretical model provided in Appendix A. This effectively reduces the haircuts applied by the clearing firm with respect to non-clearing options specialists and market makers.[62]

**XVI. Money Market Funds under the Capital Rule**

The SEC did not change Rule 15c3-1(c)(2)(vi)(D)(1) which provides for a 2% haircut for money market funds when computing net capital.[63] The definition of money market fund is defined as a money market fund qualifying under Rule 2a-7 under the Investment Company Act of 1940.[64]

**XVII. Miscellaneous**

A. Harmonizing Securities Lending and Repo Capital Charges

The SEC considered whether to harmonize the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repo transactions.[65] Since these transactions are essentially the same from an economic standpoint, the difference in capital treatment has always been a mismatch. However, the SEC did not act on this proposal due to concerns about possible negative impact on market structure which the SEC felt merited additional study.

B. Accounting for Third Party Liens on Customer Securities Held at a Broker-Dealer

In its proposing release, the SEC requested comment on how third party liens against customer fully paid securities carried by a BD should be treated under the Financial Responsibility Rules.[66] Specifically, the SEC asked if a BD should be required to (1) include the amount of a customer's obligation to third parties as a credit item in the reserve formula, (2) remove the securities subject to the lien into a separate pledge account in the name of pledgee or pledgees, or (3) record it on books and records and disclose to the customer the existence of the lien, the identity of the pledgee obligation and the amount of security subject to the lien or a combination of these. The SEC was concerned that conflicting liens would increase the cost of SIPC liquidation and the fund administered by SIPC. The SEC did not take action with this issue at this time, choosing to further investigate and study the issues.[67]

**XVIII. Conclusion**

In this article, the authors have attempted to identify, discuss and briefly comment on the major changes and amendments to the rules and interpretations by the SEC staff. Although the Adopting Release is over 300 pages, it is worth reading because the SEC discusses its thinking on many of the changes and amendments which may not be clear on their face. In addition, the SEC in the Release responds to the many comments by the industry and industry service providers, including discussion of revisions implemented or rejected due to such comments. This provides further insight into the SEC thinking on the amendments. Given the scope of these amendments (and the sheer size of the Adopting Release), that additional insight can be helpful. ✦

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(Endnotes)

1 *Mr. Uhlenhop and Mr. Ruark are members of the law firm of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., Chicago, Illinois. Mr. Uhlenhop is a member of the Illinois and New York bars. Mr. Ruark is a member of the Illinois bar. The contributions of Suzanne Hennessey, Legal Assistant are gratefully recognized.*

2 34 Act Rel. No. 34-70072 (July 31, 2013); 17 CFR 240.15c3-1, 240.15c3-2, 240.15c3-3, 240.17a-3, 240.17a-4, 240.17a-11 (Adopting Release). 34 Act Rel. No. 34-70073 (July 31, 2013); 17 CFR 240.17a-5, 17a-11; (June 15, 2011) (Reports Adopting Release) (collectively, the "Releases").

3 Originally Proposed in SEC Rel. No. 34-55431, 72 FR 12862 (Mar. 9, 2007) ("Proposing Release").

4 34 Act Rel. No. 34-64676, 76 FR 37572 (June 27, 2011) ("Reports Proposing Release").

5 SEC Rules may be found at 17 CFR 240 *et seq.*; 17 CFR 240.15c3-3. The CFR cites in this article will be omitted and SEC Rules cited by their SEC Rule number.

6 SEC Rule 15c3-3.

7 Adopting Release, p. 16; Rule 15c3-3(a)(16).

8 *See* 34 Act Rel. No. 9856 (Nov. 10, 1972).

9 Adopting Release, p. 16; Rule 15c3-3.

10 Proposing Release, pp. 3, 4.

11 Under the rule, satisfactory control locations include regulated securities clearing agencies, US banks, and, with the approval of the Commission, certain foreign financial institutions. In order to meet the possession or control requirement, a broker-dealer must determine on a daily basis the amount of customer fully paid and excess margin securities (by issuer and class) it holds for customers. It then compares that amount with the amount of securities it holds free of lien in its own possession or at one of the satisfactory control locations. Proposing Release, pp. 3-4.

12 Proposing Release, p. 4.

13 SEC Rule 15c3-3e.

14 In the event a BD on a monthly basis has aggregate indebtedness in excess of 800% of net capital, the BD must thereafter compute weekly for four weeks, during none of which the aggregate indebtedness exceeded 800% of net capital. BDs that do not carry customer accounts and have only proprietary accounts may compute monthly rather than weekly. Computations also may be made at any time as of the close of any business day and the deposit so computed made one hour after opening of banking business on the second following day. If a BD performing the computation with respect to PAB accounts on a monthly basis is at any time required to deposit additional cash or qualified securities in the PAB reserve bank account, the BD must thereafter perform computations required on a weekly basis for four consecutive weeks. None of which is made at a time when the BD is required to deposit additional cash or qualified securities in the PAB reserve account. 15c3-3(a)(1).

15 15 U.S.C. 78aaa *et seq.*

16 SEC Rule 15c3-3(a)(i).

17 15 U.S.C. 78iii(2).

18 Adopting Release, pp. 13-14.

19 *See* Adopting Release, p. 15; Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation Commission to Raymond J. Hennessy, Vice President of NYSE and Thomas Cansella, Vice President of NASD Regulation, Inc. (Nov. 10, 1998).

20 Adopting Release, p. 16; SEC Rule 15c3-3(a)(16).

21 Adopting Release, p. 24, *et seq.*

22 Amended SEC Rule 15c3-3(e).

23 Adopting Release, p. 25.

24 Adopting Release, pp. 10-14.

25 Adopting Release, pp. 15-16.

26 Adopting Release, pp. 24-25.

27 Adopting Release, pp. 21-23.

28 Adopting Release, p. 16.

29 SEC Rule 15c3-3(a)(16); Adopting Release, p. 20.

30 Adopting Release, pp. 29-41.

31 Adopting Release, p. 73

32 Adopting Release, p. 126.

33 Adopting Release, pp. 41-46.

34 Adopting Release, pp. 61-63.

35 Adopting Release pp. 61-63; SEC Rule 15c3-3(j).

36 Effective date September 30, 2013.

37 Adopting Release, p. 59; *see* SEC Rule 15c3-3(j)(2)(ii)(A), as adopted.

38 *Id.* Adopting Release, pp. 60-61. The proposed rule stated the "customer has previously affirmatively consented to such treatment of the free credit balances after being notified of…." In addition, as noted above, the phrase "accounts opened on or after the effective date of this paragraph" was deleted from proposed paragraph (j)(2)(ii) and moved to paragraph (j)(2)(ii)(A), with the reference to specific paragraph (j)(2)(ii) inserted after the word "paragraph." Moving this phrase to paragraph (j)(2)(ii)(A) simplifies the final rule by eliminating the necessity of codifying two largely overlapping sets of conditions, with three of the conditions being repeated in both paragraphs. The effect of this change is to make the first condition only applicable to new accounts and the remaining conditions (paragraph (j)(2)(ii)(B)(1) through (3)) applicable to both new and existing accounts. The word "accounts" also has been replaced with the phrase "an account." Adopting Release, p. 61 FN 199.

39 *See* Adopting Release, pp. 59-61 ("[T]he customer would need to agree prior to the change (*e.g.,* in the account opening agreement) that the broker-dealer could switch the sweep option between those two types of products.").

40 *See* paragraph (j)(2)(ii)(A)(2) of SEC Rule 15c3-3, as adopted.

41 Adopting Release, p. 65, FN 111.

42 Adopting Release, p. 67, *et seq.*

43 *See* 17 U.S.C. §4d(a); CFTC Rule 1.20-e.

44 *See* CFTC Rule 1.3(y); 17 CFR 1.3(y).

45 Adopting Release, p. 69.

46 *See* 17 U.S.C. §4d(a); CFTC Rule 1.20-e.

47 *See* Pub. L. No. 111-203 §983.

48 Adopting Release, pp. 80-82.

49 Adopting Release, p. 79.

50 Adopting Release, pp. 82-89.

51 *See* 2000 Master Securities Loan Agreement, Annex 1, published by the Bond Market Association, now the Securities Industry and Financial Markets Association.

52 SEC Rule 17a-11(c)(5).

53 15 U.S.C. 78a(42).

54 Adopting Release, pp. 89-92.

55 *See* SEC Rule 17a-4(e)(9).

56 Adopting Release, p. 97, *et seq.*

57 Adopting Release, p. 101, *et seq.*

58 Adopting Release, p. 111.

59 Adopting Release, p. 112, *et seq.*

60 Adopting Release, p. 121, *et seq.*

61 Adopting Release, p. 121; SEC Rule 15c3-1(e)(3)(i).

62 Adopting Release, p. 122.

63 Adopting Release, p. 124.

64 15 U.S.C. 80(a), *et seq.*

65 Adopting Release, p. 130.

66 Adopting Release, p. 82.

67 Adopting Release, p. 130.

# Why Compliance Needs To Pay Attention To Foreign Exchange Risk In Client Accounts

By: William Dale

While international investments have proven to be a popular source of diversification for US investors, these securities come with various forms of foreign exchange risk which are often difficult to discern and all too often left unaddressed. Foreign Exchange ("FX") risk extends beyond the effects of embedded FX volatility in an international asset. It includes risks associated with the manner in which foreign assets are valued in US Dollar terms and the opacity with which currency is exchanged when purchasing international securities. Regardless of how unaware market participants may be of these risks, they exist and must be addressed.

In addition, scrutiny of the foreign exchange markets has never been higher among global regulators as investigations spanning five continents continue to be documented weekly on the front pages of both financial and mainstream media. Now more than ever, compliance officers, directors and fiduciaries need to be aware of foreign exchange risk in clients' portfolios and how such risks are being identified, disclosed and were possible, managed.

In this three part series, we will explore various risks associated with the foreign exchange element of international investing beginning with a look at FX transactional risks. Given the structural opacity of FX markets and investors' expectations for "best execution", there exists a unique set of disclosure and possibly fiduciary risks as it relates to how FX orders are placed and prices are validated. Over-the-counter ("OTC") FX does not naturally operate in a way that promotes "best execution". Fortunately, new disruptive technologies in FX are addressing these issues and allowing institutions to manage transactional risks in ways previously unavailable. To better understand these risks, we must start with an understanding of the foreign exchange market and how it has evolved into its present form.

**FX Markets: A Recent History**

Over the last twenty-five years, the growth of global economic trade, movement of investment capital across borders, and the proliferation of financial technologies have contributed to the tremendous growth in volume of daily, foreign exchange ("FX") dependent financial transactions. Today daily volume of FX transactions underpinning these activities is estimated to be in excess of $5 trillion USD[1], largely occurring OTC through discreet electronic and verbal communications and without the benefit of transparent price discovery.

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Over the same period of time, the mutual fund industry in the US has grown from a total of $980 Billion USD in assets to over $15 Trillion USD[2]. This growth has forced asset managers and brokers alike to broaden investor mandates and seek diversified returns in foreign markets. Today, US broker dealers hold over $2 Trillion USD in global equity funds and over $1 Trillion in American Depositary Receipts (ADRs) on behalf of investors. There are now more assets invested in international securities vehicles registered in the US than were invested in the entire US mutual fund industry in 1994. This growth has drawn new participants and significant volume to a unique marketplace that operates in a very different manner than one might expect.

Modern FX markets started with a collection of independent, bi-lateral transactions that were negotiated between clients who required a foreign exchange facility and banks that provided this service. Whether clients' requests were to exchange one amount of currency for another in two days or less (a "spot" transaction) or to settle payments after a period of three days or more (a "forward" transaction), the nature of the transaction was largely the same in that a bank would accept an obligation to deliver an amount of currency as requested by the client and take on market, credit and settlement risk in order to do so. Such risk would be priced into the net amount offered to the client as an embedded, non-transparent fee or price 'mark-up'.

To manage the residual market risk of accepting such orders, multi-national banks set up an interbank network of FX dealers who would trade with one another in an attempt to net out risk. Eventually this network of relationships would work together to help facilitate the development of a global payment and settlement system that has helped to significantly reduce credit and settlement risks industry-wide making this market one of the most stable in the world. Regardless of how volatile the market environment, this is a market that has remained robust and liquid through the worst of times. Nevertheless, FX dealer banks still have to manage the daily market risk they assume when facilitating the foreign exchange needs of the world's capital markets.

As interbank FX trading activity between FX dealing banks grew, an industry of interdealer FX brokers emerged through the 1970's and 80's. These brokers would become the central conduit for institutional buyers to reach institutional sellers as market participants looked to clear FX market risk off their books and would charge an additional embedded fee or price 'mark-up' for their service. Despite the added efficiency of improved connectivity, fragmentation and opacity remained a structural feature of FX markets. Eventually these markets would grow in size and complexity, evolving into an electronic marketplace. The 1990's introduced a new form of electronic FX brokering via electronic communications networks (ECNs). The earliest of these platforms would eventually grow into the largest of the electronic FX ECNs.

Other electronic FX brokering platforms would emerge in the following decade as the electronic FX market became widely accessible to a broader array of institutional participants. This was made possible through the innovation of FX prime brokerage services, where clients could now trade FX in the name of their bank on the very electronic platforms where previously only banks could transact with one another. Nevertheless, these new FX platforms would maintain largely the same brokerage business model as the original interbank brokers. Namely, they would exist to facilitate transactions that pass FX market risk from one party to another party willing to accept it.

The liquidity pools on these platforms were designed to be fragmented. Unlike a regulated exchange with central clearing, participants on the electronic platforms would only see bespoke liquidity on the system determined by their credit limitations, trading history or even at the discretion of the platform. With a business model based on volume and transactional revenue (transparent or not) most of the FX ECNs began catering to an emerging industry of High Frequency Traders (HFTs) who would drive FX volumes and FX ECN revenues to the impressive levels we see today.

As speeds and tactics of HFTs evolved, banks who used to post interest on these electronic platforms to remove risks from their books found they were inadvertently taking on new risk, often at the expense of their profitability. Without an ability to 'see' the market as fast as the larger HFTs, banks have become less inclined to post interest in these markets and as a result, the largest FX ECNs are in a state of decline as it relates to volume and liquidity.

A few of the largest FX dealers have gravitated to internalizing their order flow. This is really only possible for the largest FX dealers given the size of their client base and economies of scale. This business strategy may look low risk in the short term but it carries with it long term risks. Keeping clients fragmented from competitive markets has not proven to be sustainable for any industry in the electronic age nor defensible when conflicts are exposed.

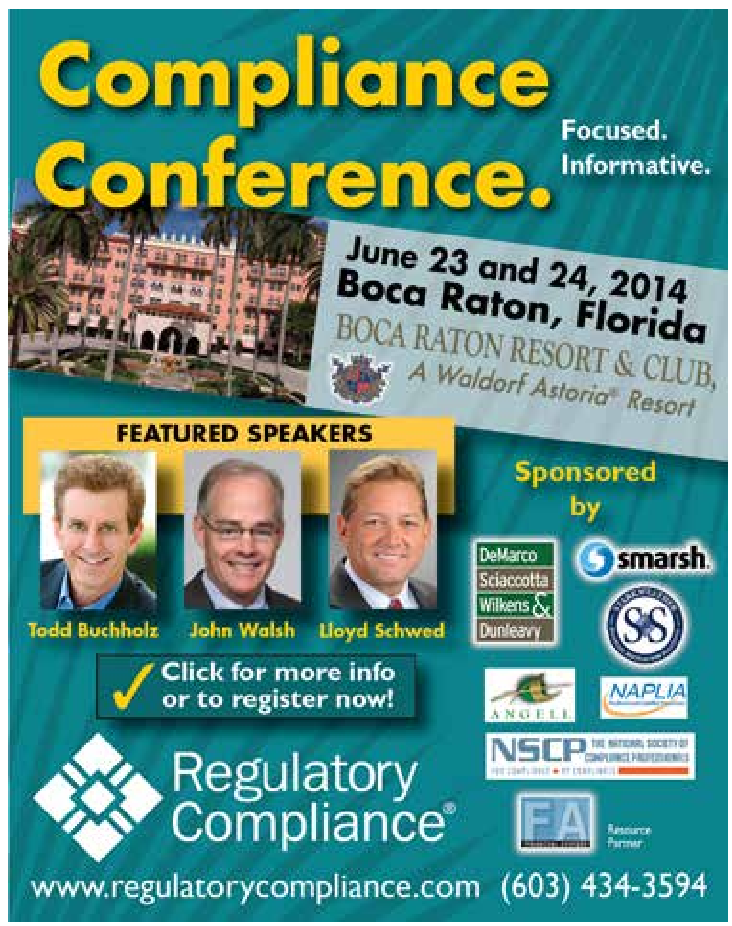
While a few of the largest FX dealing banks have internalized their order flow, the vast majority of banks are in the process of moving toward an agency model. They are managing their market risk by eliminating it. By facilitating client access directly to the broader institutional FX market as opposed to acting in a principal capacity, these banks can provide client access to liquidity without taking on market risk themselves. Such models are providing unprecedented transparency but require new technologies that provide audit trails and independent price validation to ensure there are no undisclosed conflicts of interest. These new technologies are also fostering new business models that allow banks to shift away from principal based, bi-lateral transactions by connecting to new "exchange-like" FX platforms that operate with different operational and business models than legacy FX ECNs. The new FX platforms are enabling access to an unprecedented form of "best execution" for FX through existing Direct Market Access ("DMA") technologies at the same banks who still deal FX with the majority of their clients on a principal basis.

The newest of the electronic FX platforms are facilitating innovative models with disruptive technologies that can allow simultaneous dealers to stream firm orders to real-money participants in an environment that is open, transparent, auditable and fair to all participants regardless of their speed or apparent informational advantage. These FX platforms are being widely embraced by the majority of major FX dealer banks who are streaming firm quotes and executable liquidity onto these platforms 24/5. In essence, the business model of electronic FX platforms that operate like the interbank brokerages of decades past and who now cater to HFT are being challenged by FX platforms that operate more like regulated equity exchanges and cater to real-money clients. This is good news for investors and fiduciaries who must transact in FX in order to fulfil international investment mandates. The barriers that have fragmented global FX markets are beginning to fall.

**Managing FX Transactional Risks**

Market participants who trade securities on regulated, public stock exchanges have come to expect a standard for price discovery and best execution when transacting financial assets. They have also come to expect a level of market transparency and equal access to information as is understood to exist on the National Best Bid and Offer (NBBO) and Consolidated Tape System (CTS). As one can see when looking at its history, OTC FX markets were never built to operate in this manner.





Until recently, broker dealers, fiduciaries and public investment boards of directors generally took very little notice of FX markets. Albeit a common buy-side activity, converting currencies for payments was largely an afterthought following a series of foreign securities transactions and was considered an administrative function at best. In most cases, FX transactions were left as end-of-day standing instructions with a single counterparty that lacked a competitive incentive to price the transaction aggressively. Further complicating the matter for buy-side participants was a lack of reliable data that could be used for post-trade transaction cost analysis. Without a CTS equivalent in FX, finding price, time and amount comparisons was difficult if not impossible. While most would admit there was likely a "transactional risk", it was difficult to quantify and thus went largely ignored.

Over the past four years, well publicized whistleblower lawsuits alleging egregious off-market FX execution rates and ensuing regulatory investigations have begun to change all of that. The FX industry is in the middle of a generational transformation and compliance officers, like most financial professionals in positions of oversight, need to be paying close attention to emerging best practices for FX transactions.

There are many reasons Investment Advisors and Broker Dealers choose to send their orders to a single counterparty when executing a financial transaction on behalf of a client. The question that exists for compliance officers, directors and fiduciaries should be whether or not these reasons are aligned with their clients' interest. If not, are conflicts disclosed adequately? Is management even aware of such conflicts? Are investors and intermediaries who may not be familiar with FX markets adequately prepared to manage the effects of opaque but very real FX transaction risks?



The growing trend away from opacity and toward transparent best execution in FX is being facilitated by new electronic FX platforms that can be accessed via FX Prime Brokerage or through banks that offer Direct Market Access (DMA) to such next generation FX "exchanges" or ECNs. This means that traditional FX credit lines at many banks may now be used to access multi-contributor platforms where there is competition for an order. Rather than ask your bank or custodian for a price, ask them for DMA access to a transparent ECN where prices can be audited by a third party, such as a benchmark market index provider. Ensure the platform can provide independent validation of time, price and depth of market data for post trade analysis with proof that multiple dealers were competing for an order as one would expect on a regulated exchange.

Ultimately, if emerging best practices in FX order management are achieving a form of execution that is more aligned with investors' expectations for "best execution", shouldn't these be considered? With growing scrutiny on the part of regulators in this area, this is a timely topic of discussion for compliance managers, Chief Risk Officers and governance boards. As experienced professionals know, it's best to get ahead of these trends when they begin to shift.

Compliance officers may want to investigate their principal transaction disclosure policy where brokers add mark-ups to wholesale FX prices. Furthermore, they may wish to recommend reviews of how FX is transacted. Where clients expect 'best execution', are they getting it in FX? Are wholesale rates being derived from a single source? Are indications of interest revealed to bi-lateral parties prior to a quotation being offered? If so, expectations of "best execution" are unlikely being met. Is this a matter of disclosure or are there better ways to manage this risk?

The exploration of new FX platforms that are offering "exchange-like" transparency at the point of execution should be considered in the context of best practices when considering how to manage transactional risks associated with FX executions. With new DMA facilities at many leading FX banks, accessing "best execution" in FX may be easier than ever. But don't expect it to be on next month's brochure. New business models are not adopted simultaneously by institutions. As with all innovation, there will be early adopters and those who will act on client demand or competitive pressures. This is an exercise that will require diligence and effort but in the end, it's the investors who win.

Next month we will take a closer look at how these execution rates are finding their way into the FX fixing rates that are used to value trillions of dollars in assets every day. The Financial Times has recently announced that regulatory and legal probes into FX fixing rates are likely to rival the LIBOR investigations and the ramifications to global capital markets could be larger. We'll explore the growing market impact of asset managers trying to align their FX executions with indicative end-of-day FX fixing rates as opposed to standards of best execution. We'll also look at new alternative approaches to calculating FX benchmarks emerging in the marketplace that are more closely aligned with principals of best execution. This is a topic that all compliance officers, directors and fiduciaries will want to watch closely. ✦

1 The Bank for International Settlements,
Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013
2 ICI Statistics Publications, 2013 Fact Book and **Worldwide Mutual Fund Assets & Flows Supplementary Tables,**
Worldwide Mutual Fund Market Data, Fourth Quarter 2013. These figures include Closed-End funds and ETFs.
Download a copy of the white paper: "Real-time Currency Valuation in the Global FX Marketplace" at http://www.curexgroup.com/documents/White%20Paper%20-%20Real-Time%20Currency%20Valuation%20in%20the%20Global%20FX%20Marketplace.pdf

# An Analysis of the Potential Impact of a Uniform Fiduciary Standard Upon Broker-Dealers, Registered Investment Advisers, and Dually-Registered Advisers

By James J. Eccleston and Christine E. Goodrich

**I. Introduction**

Widely considered to be the most sweeping financial regulatory reform of the modern era, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law nearly three years ago. Section 913 of Dodd-Frank granted the Securities and Exchange Commission ("SEC") "discretionary rulemaking authority under the Securities Exchange Act of 1934 ("Exchange Act") and the Advisers Act to adopt rules establishing a uniform fiduciary standard of conduct for all broker-dealers and investment advisers when providing investment advice."[1] Section 913 of Dodd-Frank further required that "any standard of conduct [adopted by the SEC] shall be no less stringent than the standard applicable to investment advisers under Sections 206(1) and 206(2) of the Advisers Act."[2]

Since the SEC published its study of Investment Advisers and Broker-Dealers as mandated by Section 913 of Dodd-Frank[3] over two years ago ("Study" or "SEC Study"), the financial industry has been awaiting a determination by the SEC as to whether it will impose a heightened standard of care upon broker-dealers, similar to the fiduciary duty impliedly imposed on investment advisers pursuant to The Investment Advisers Act of 1940 ("Advisers Act"). The primary recommendations of the SEC Study were that the SEC should "engage in rulemaking to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers" and should "consider harmonizing certain regulatory requirements of broker-dealers and investment advisers where such harmonization appears likely to enhance meaningful investor protection."[4] The Study did not, however, provide information regarding the costs and benefits of the current regulatory regime as compared to the costs and benefits that would likely be realized if the SEC were to exercise its rulemaking authority. Similarly, the Study did not generate comments regarding either of the aforementioned cost-benefit analyses.

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Recently, the SEC took the next step towards a potential heightened standard when it released a Request for Data and Other Information regarding the Duties of Brokers, Dealers and Investment Advisers ("Request"). The Request specified that the SEC intends to use the data and information collected to inform its "consideration of alternative standards of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers," such as the potential establishment of a uniform fiduciary standard, as well as to inform its consideration of the "potential harmonization of certain other aspects of the regulation of broker-dealers and investment advisers."[5] Importantly, the Request also calls upon commenters to provide the SEC with a cost-benefit analysis for a uniform fiduciary standard of conduct, and the various alternative approaches thereto, as outlined in the Request.

As will be discussed in detail below, the potential implementation by the SEC of a uniform fiduciary standard, alternatives thereto and/or various other aspects of regulatory harmonization will have a substantial impact not only on financial service professionals, but also on their customers and their employers. This article will provide an overview of the current regulatory regime and traditional duties of a fiduciary, as well as an overview of the practical implications of both a uniform fiduciary standard and alternative approaches to such a standard, as well as the overall effect of the potential standards on the various stakeholders in the industry.

**II. Current Regulatory Framework and Standard of Care**

Under the current framework, broker-dealers and investment advisers are subject to different regulatory regimes, despite the fact that many of the services offered by both groups overlap. Investment advisers are subject to the Advisers Act and, as a result, owe fiduciary duties to their clients. Broker-dealers, on the other hand, are subject to the Exchange Act and are not generally considered to be fiduciaries to their customers, with some exceptions.[6] Broker-dealers are also subject to the rules of each and every self-regulatory organization ("SRO") of which it is a member. However, applicable antifraud provisions and federal securities laws are applicable to both broker-dealers and investment advisers.

Notably, studies have reflected that many retail customers are not aware of the differences between broker-dealers and investment advisers, and the corresponding duties owed to the customer.[7] This is most true in recent years where the "lines between full-service broker-dealers and investment advisers have become blurred," a fact that is especially troublesome when "specific regulatory obligations depend on the statute under which a financial intermediary is registered instead of the services provided."[8] The SEC Study and Request are an effort to both "enhance retail customer protections and decrease retail customers' confusion about the standard of conduct owed to them when their financial professional provides them with personalized investment advice,"[9] potentially through the establishment of a uniform fiduciary standard or some variation thereof.

**III. Assumptions Underlying Potential Standards Being Considered by the SEC**

In its Request, the SEC set forth various assumptions that presumably would underlie any standard it ultimately decides to impose. The general assumptions below would, for the purposes of the SEC's Request, underlie any proposed approach to adopting a uniform standard of conduct.[10]

A. "Personalized investment advice about securities" would "include a 'recommendation' as interpreted under existing broker-dealer regulation, and would include any other actions or communications that would be considered investment advice about securities under the Advisers Act."[11] "Personalized investment advice" would not, however, include "'impersonal investment advice' as used for purposes of the Advisers Act," nor would it include "general investor educational tools" so long as those tools "do not constitute a recommendation under current law."[12]

B. "Retail customer" would be defined in the same way the term is defined under Dodd-Frank, which is "a natural person, or the legal representative of such natural person, who 1) receives personalized investment advice about securities from a broker or dealer or investment adviser; and 2) uses such advice primarily for personal, family or household purposes."[13]

C. Any action taken by the SEC would be applicable to all "SEC-registered broker-dealers and all SEC-registered investment advisers."[14]

D. The uniform fiduciary standard would not require firms to charge an asset-based fee, but instead "would be designed to accommodate different business models and fee structures of firms, and would permit broker-dealers to continue to receive commissions."[15] Moreover, broker-dealers would continue to be allowed to be "engaged in, and receive compensation from, principal trades." Also, "at a minimum, a broker-dealer or investment adviser would need to disclose material conflicts of interests, if any, presented by its compensation structure."[16]

E. The uniform fiduciary standard "would not generally require a broker-dealer or investment adviser to either: 1) have a continuing duty of care or loyalty to a retail customer after providing him or her personalized investment advice about securities, or 2) provide services to a retail customer beyond those agreed to between the retail customer and the broker-dealer or investment adviser."[17] Rather, the question of whether the broker-dealer or investment adviser has a continuing duty, and the nature and scope of such duty, would be determined by the arrangement between the parties, whether contractual or otherwise, including the "totality of the circumstances of the relationship and course of dealing between the customer and the firm."[18] Moreover, the uniform fiduciary duty would not apply to, and the broker-dealer or investment adviser would not be required to provide, services beyond those agreed to through a contractual or other arrangement or understanding with the retail customer."[19]

F. The fact that a firm offers, or that a broker-dealer or investment adviser recommends, "only proprietary or a limited range of products would not in and of itself be considered a violation of the uniform fiduciary standard of conduct."[20]

G. The rules applicable to investment advisers, namely Sections 206(3) and 206(4) of the Advisers Act would continue to apply to investment advisers but would not become applicable to broker-dealers. To satisfy the fiduciary standard, a broker-dealer would be required to "disclose any material conflicts of interest associated with its principal trading products."[21]

H. Currently applicable "law and guidance governing broker-dealers, including SRO rules and guidance, would continue to apply to broker-dealers."[22]

As with all the assumptions in the Request, including but not limited to those listed above, the SEC has expressly stated that such assumptions should not be taken as a suggestion of the agency's policy view or the ultimate direction of any proposed action.[23] It seems clear, however, that at a minimum, the assumptions provide a road map of the various factors that the SEC is taking into account while analyzing the potential implications of a uniform fiduciary standard, or alternatives thereto.

**IV. Potential Standards Under Consideration by the SEC**[24]

**A. Uniform Fiduciary Standard**

As discussed above, Section 913 of Dodd-Frank requires the SEC, if it determines to exercise its rulemaking authority to enact a uniform fiduciary standard (or some variation thereof), to adopt a standard no less stringent than the standard applicable to investment advisers under Sections 206(1) and 206(2) of the Advisers Act.[25] These sections of the Advisers Act have been interpreted by the Supreme Court as "requiring an investment adviser to fully disclose to its clients all material information that is intended to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."[26] The SEC Study recommended that any uniform standard should necessarily include both a duty of loyalty and a duty of care, as well as the extension of "existing guidance and precedence under the Advisers Act regarding fiduciary duty…where similar facts and circumstances would make guidance and precedent relevant and justify a similar outcome."

1. Duty of Loyalty

Section 913(g) of Dodd-Frank addresses the duty of loyalty as a crucial component of a uniform fiduciary standard, indicating that, at a minimum, when a broker-dealer or investment adviser provides personalized investment advice, "any material conflicts of interest shall be disclosed and may be consented to by the customer."[27] Consistent with Dodd-Frank, the establishment of a uniform fiduciary standard would necessarily be "designed to promote advice that is in the best interest of a retail customer"[28] by eliminating the "material conflicts of interest of a broker-dealer or investment adviser, or by "providing full and fair disclosure to retail customers about those conflicts of interest."[29] The SEC has stated that it should be assumed that the agency would provide specific guidelines as to how broker-dealers and investment advisers could comply with the duty of loyalty component of the uniform fiduciary duty standard.

The SEC has further articulated that commenters may make several assumptions regarding the duty of loyalty. Firstly, any standard the SEC would impose would include details of various disclosure requirements, including, but not necessarily limited to, the disclosures listed below.[30]

a) A generalized obligation to disclose all material conflicts of interest with regard to that specific retail customer, which "could be made largely through the general relationship guide" described below.[31]

b) A "general relationship guide similar to Form ADV Part 2A" which would be delivered to the customer "at the time of entry into a retail customer relationship" and would contain, at a minimum, a description of the firm's "services, fees and the scope of its services with the retail customer."[32] The description of the scope of the firm's services would need to include, but not be limited to, the following:

i) Whether "the advice related duties are limited in time or are ongoing, or are otherwise limited in scope (e.g. limited to certain accounts or transactions)"[33]

ii) Whether "the broker-dealer or investment adviser only offers or recommends proprietary or other limited ranges of products;"[34] and

iii) Whether "the broker-dealer or investment adviser will seek to engage in principal trades with a retail customer"[35] and if so, the circumstances in which he or she would seek to do so.

c) Any rule imposed upon broker-dealers and investment advisers would "treat conflicts of interest arising from principal trades the same as other conflicts of interest."[36] This is in contrast to "transaction-by-transaction disclosures and consent requirements of Section 206(3) of the Advisers Act for principal trading."[37] Any rule established would expressly state that the aforementioned disclosures under Section 206(3) are not applicable, however "at a minimum, as with other conflicts of interests, the broker-dealer or investment adviser would be required to disclose material conflicts of interest arising from principal trades with retail customers."[38]

d) Any rule would prohibit the "receipt or payment of non-cash compensation (*e.g.*, trips and pries) in connection with the provision of personalized investment advice."[39]

2. Duty of Care

The SEC indicated in its Request that it could utilize the duty of care to specify "certain minimum professional obligations of broker-dealers and investment advisers" in order to promote the dissemination of investment advice that is in the "best interests of the retail customer."[40] The duty of care likely would be used to set a minimum standard of care under both existing law and any new law imposed by the heightened standard. Additionally, as set forth in the SEC Request, the duty of care likely would incorporate the components below.[41]

a) Similar to the current regulatory regime, broker-dealers and investment advisers would be required to have a reasonable basis to "believe that [their] securities and investment strategy recommendations are suitable for at least some customer(s) as well as for the specific retail customer to whom it makes the recommendation in light of the retail customer's financial needs, objectives and circumstances."[42]

b) Certain products recommended by investment advisers and broker-dealers would be subject to additional requirements, such as "specific disclosure, due diligence or suitability requirements."[43] Examples of products that would be subject to these product-specific requirements may include, but not be limited to, penny stocks, options, debt securities and bond funds, municipal securities, mutual fund share classes, interests in hedge funds and structured products.[44]

c) Broker-dealers and investment advisers (in cases where "the investment adviser has the responsibility to select broker-dealers to execute client trades"[45]) would be required to "seek to execute customer trades on the most favorable terms reasonably available under the circumstances."[46]

d) Broker-dealers and investment advisers would be required to receive fair and reasonable compensation for their services, taking into account "all relevant circumstances."[47]

3. Continuing Application of Existing Fiduciary Principles

The SEC Study did recommend that "existing guidance and precedent under the Advisers Act regarding fiduciary duty should continue to apply to investment advisers and be extended to broker-dealers, as applicable, under a uniform fiduciary standard of conduct."[48] Nonetheless, the SEC noted in the Request that application of relevant guidance and precedence is a fact-specific determination based upon the circumstances surrounding each case and consequently, the guidance and procedures may not apply to broker-dealers in certain cases. At a minimum, the SEC Request identified the principles listed below as those that would "continue to apply to investment advisers and be extended to broker-dealers."[49]

a) The duty of loyalty inherent in a fiduciary duty standard would generally "require a firm to disclose to a retail customer how it would allocate investment opportunities among its customers, and between customers and the firm's own account."[50] This would include, but not be limited to, disclosures regarding the firm's "method of allocating shares of initial public offerings, as well as its methods of allocating out of its principal account to its customers when agency orders are placed on a riskless principal basis."[51]

b) Orders may be aggregated or "bunched" by a firm on behalf of two or more retail customers, "so long as the firm does not favor one customer over another."[52] The firm would be required to disclose that it aggregates orders, and under what conditions it does so. If the firm does not aggregate orders, it would then be required to state why it does not when it has the opportunity to aggregate, as well as the practices and costs associated with not aggregating orders.

**B. Alternative Approaches**

In its Request, the SEC also identified several alternatives to the uniform fiduciary standard previously discussed. The SEC hopes that it will receive comments, as well as a cost-benefit analysis of the alternative approaches detailed below. The purpose is to help the SEC evaluate whether the various alternatives meet the goals of enhancing retail customer protections and decreasing retail customers' confusion about the standard of conduct owed to them in connection with the rendering of personalized investment advice. The SEC suggests the following alternatives in the Request:

1. Without imposing a fiduciary standard of conduct, the SEC may decide to apply a uniform requirement to broker-dealers and investment advisers which would require them "to provide disclosures about: a) key facets of the services they offer and

the types of products or services they offer or have available to recommend; and b) material conflicts they may have with retail customers."[53]

2. The SEC may decide to impose the uniform fiduciary standard of conduct on broker-dealers and investment advisers, but may decline to extend the existing fiduciary duty guidance and precedent under the Advisers Act to broker-dealers. However, the aforementioned guidance and precedent would still be applicable to investment advisers.[54] As will be discussed in greater detail below, this is the approach advocated by The Securities Industry and Financial Markets Association ("SIFMA").

3. The SEC may determine that it will leave the current regulatory scheme applicable to investment advisers unchanged, while applying the uniform fiduciary standard to broker-dealers, in part or as a whole. The SEC stated in the Request that this "'broker-dealer only' standard could involve establishing a 'best interest' standard of conduct for broker-dealers"[55] that would still meet Dodd-Frank's requirement that any heightened duty imposed on broker-dealers must be no less stringent than the standard currently applied to investment advisers.

4. Alternatively, the SEC may decide that it will leave the current broker-dealer regulatory regime unchanged while specifying certain minimum professional obligations under an investment adviser's duty of care, as currently such duties are not specified by rule.[56] If the SEC pursued this approach, "any rules or guidance would take into account Advisers Act fiduciary principles and … seek best execution where the adviser has the responsibility to select broker-dealers to execute client trades."[57]

5. The SEC also could look abroad to successful models employed in other international markets. In the United Kingdom, the Financial Services Authority ("FSA") requires "persons providing personalized investment advice to a retail client to act in the client's best interests."[58] The FSA has also "set limits on the amount investment advisers charge for their services, including prohibiting (a) the receipt of ongoing charges unless there are ongoing services, and (b) the receipt of commissions from those providing the investment advice."[59] Similar yet distinguishable policies and standards are employed by Australia, as well as the European Securities and Markets Authority.[60]

6. Finally, the SEC could take no action at all, and leave the current regulatory regime for broker-dealers and investment advisers unchanged. Consequently, the SEC seeks comments regarding the costs and benefits of leaving the current regulatory framework intact, as compared to implementing one of the aforementioned alternatives and/or a uniform fiduciary standard.

**V. A Fiduciary's Duties: Obligations and Best Practices**

In order to determine how the various approaches discussed above would affect the personal finance industry, it is important to highlight the various obligations traditionally associated with a fiduciary, as these duties will likely be incorporated, to some degree, into any heightened standard which may be imposed on broker-dealers and investment advisers. An excellent resource for doing so is the Institute for the Fiduciary Standard (the "Institute") which has identified six core duties inherent in a fiduciary standard, and the various attributes accompanying each of the duties.[61]

<u>a. Serve in the Client's Best Interest</u>

A fiduciary is defined as "someone acting in a position of trust on behalf of, or for the benefit of, a third party."[62] As such, a fiduciary owes the utmost duty of loyalty to his/her clients. This duty requires the fiduciary to place the client's best interests first, ahead of the interests of all other stakeholders, including the adviser and the firm. In order to satisfy, a fiduciary must ensure that there is no option available to the client which is "materially better."[63] In connection with serving the client's best interests, there are several responsibilities that a fiduciary must undertake, including, but not limited to the following:[64]

i) "Determining investment goals and objectives;

ii) Choosing an appropriate asset allocation strategy;

iii) Establishing an explicit, written investment policy consistent with [the client's] goals and objectives;

iv) Monitoring the activities of the overall investment program for compliance with the investment policy."[65]

A fiduciary also has the duty to select asset classes that are consistent with the identified risk, return and time horizon specified by the client.[66] The "key fiduciary inputs" involved in asset allocation strategy may be defined by the acronym "TREAT: tax status, risk level, expected return, asset class performance and time horizon."[67]

<u>b. Act in the Utmost Good Faith</u>

A fiduciary is required to act in the utmost good faith of the client. This includes, but is not limited to, the duty to be truthful and straightforward in all communications. Communications include not only direct statements spoken to the client, but all statements, whether spoken or written, regarding the adviser, the adviser's experience and recommendations, and the adviser's firm.[68]

<u>c. Avoid Conflicts of Interest</u>

Historically, concerns regarding conflicts of interest in large part prompted the enactment of the Advisers Act of 1940, as conflicts of interests abounded after the stock market crash of 1929.[69] Since the enactment of the Advisers Act, the duty to avoid conflicts of interest has been a bedrock principle for fiduciaries. It has been noted that "even well-meaning advisers often cannot overcome a conflict and give objective advice."[70] It is essential that advisers closely monitor any potential conflicts they may have. While it is impossible for an advisor to avoid every potential conflict of interest, all advisers should take reasonable steps to avoid material conflicts and must "sharply minimize unavoidable [conflicts of interest] and effectively mitigate or manage conflicts in the best interests of the client."[71]

As a practical matter, if a fiduciary suspects that he or she may have a conflict of interest, it is likely such a conflict does exist and it is the duty of the adviser to end and/or avoid the conflict.[72] To evaluate whether a conflict exists, prior to selecting a particular investment or making a certain decision with regard to the client's account, an adviser should determine who stands to benefit most from the transaction or decision.[73] If the adviser determines that anyone other than the client stands to gain the most benefit, that fiduciary is on the verge of breaching his or her duties to the client.

<u>d. Disclose and Manage All Material Facts and Conflicts</u>

As part of their fiduciary duty, investment advisers have a duty to disclose and manage all material conflicts they encounter in the course of the relationship with their clients. What an adviser is required to disclose to his or her clients depends upon the surrounding facts and circumstances. Disclosure of all material facts and conflicts required to be made by an adviser must be "clear, complete and timely."[74] When an adviser discloses material facts and conflicts in this manner, it helps the adviser to manage the material conflict. The adviser must have a reasonable basis to "think that the client fully understands the disclosure and the implication of the conflict(s), prior informed written consent if the client wishes to proceed with a transaction, and continued demonstration by the adviser that the recommendation is reasonable, fair and in the client's best interests."[75]

Pursuant to a recent rule proposal promulgated by the Financial Industry Regulatory Authority, Inc. ("FINRA"), brokers soon may be required to disclose incentives "to anyone they solicit for one year following their transfer to a new firm."[76] These incentives would include, but not be limited to, signing bonuses, upfront or back-end bonuses, loans, accelerated payouts and transaction assistance, and would only apply to incentives totaling $50,000 or more.[77] In response to FINRA's proposal, SIFMA stated that, consistent with its support of a uniform standard of conduct, "in the context of recruiting-related bonus payments, the most important and relevant information for the client is to understand the potential conflict associated with the payment."[78] In the event the proposed FINRA rule is adopted, brokers would have the duty to disclose compensation incentives, as such incentives would constitute conflicts of interest.

e. Act Prudently with the Care, Skill and Judgment of a Professional

The requirement that advisers act prudently, and with due care, with regard to his or her clients encompasses not only following "a prudent process" but also having the requisite "knowledge to make appropriate recommendations."[79] Advisers not only must possess the requisite knowledge, but also must ensure that their knowledge base and expertise are regularly updated. In order to exercise due care, an adviser's process with regard to making and monitoring investments must be prudent, and requires "investigating and assessing an investment's or firm's characteristics based on objective criteria", as well as employing industry best practices to "investigate, evaluate and construct a portfolio or recommendation."[80]

f. Control Investment Expenses

A fiduciary also has an obligation reasonably to control investment-related costs and expenses. Inherent in this duty is the obligation of the adviser to ensure all investment-related expenses are both "fair and reasonable in relation to the services and investments offered."[81] Importantly, any inappropriate or unnecessary expenses are unambiguously considered to evidence a breach of the duty of loyalty.[82] To fulfill its duty to manage investment decisions with the "requisite level of care, skill and prudence", a fiduciary is required to establish a process by which to ensure that the client is responsible only for reasonable and necessary expenses.[83] Such expenses may include, but are not limited to, trading costs, consulting and administrative fees and custodial charges.[84]

Finally, another key principle of the concept of a fiduciary is that the fiduciary duty is incapable of being superseded by agreement. A fiduciary is under an absolute obligation to "act in good faith and deal fairly with and for the principal."[85] Consequently, a "principal could not authorize a fiduciary to act in bad faith."[86]

**VI. Industry Considerations Regarding A Heightened Duty**

In response to the SEC Study, several industry groups have filed comment letters advocating the adoption of various standards. In particular, an analysis of two notable commentators, SIFMA and the Institute for the Fiduciary Standard (the "Institute"), provides insight into several important considerations regarding the aforementioned approaches.

SIFMA has taken the position that a wholesale extension of the fiduciary standard currently applicable to investment advisers pursuant to Section 206 of the Advisers Act would result in adverse consequences for both investors and the industry. While the Institute advocates for a uniform standard as well, its position differs fundamentally from the position of SIFMA.

SIFMA

SIFMA supports "the adoption of a new uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers."[87] To support its position, SIFMA notes that a wholesale extension of the current fiduciary standard would not be in the best interests of retail customers, as it would "impact choice, product access and affordability of customer services."[88] Moreover, according to SIFMA, wholesale extension of the current standard would also cause commercial, legal, compliance and supervisory"[89] problems for broker-dealers.

SIFMA notes that the inherent difficulty in extending the standard is evidenced in part by the core differences between the services provided by investment advisers and broker-dealers. While investment advisers are generally "engaged in the business of providing advice about securities for a fee, or managing assets on a discretionary basis,"[90] broker-dealers provide securities-related advice in addition to a host of other products and services which are beneficial to customers and securities markets as a whole. Those additional activities engaged in by broker-dealers "often carry inherent (though generally accepted and well-managed) conflicts of interest" and the current fiduciary duty standard implied under the Advisers Act "provides incompatible and insufficient guidance for broker-dealers on how to manage, disclose or obtain consents to these conflicts."[91] Notably, the fact that commission-based brokerage accounts are the "preferred model for retail customers"[92] could result in reduced access for customers, as numerous potential conflicts may arise in such accounts. Although Dodd-Frank provides that commission-based compensation in and of itself would not constitute a violation of a uniform fiduciary standard, SIFMA's position is that "undifferentiated application of existing Advisers Act case law, guidance and other precedents to broker-dealers could result in reduced access to brokerage accounts"[93] since presumably such precedence may support a finding that a material conflict existed in a commission-based account, depending upon the circumstances.

SIFMA has outlined several key reasons why, in its opinion, the fiduciary standard under the Advisers Act should not extend to broker-dealers. Notably, Congress "recognized that the uniform fiduciary standard should 'appropriately adapt to the differences between broker-dealers and registered investment advisers.'"[94] Also, SIFMA has stated that extending the "inability to gauge compliance with, or legal exposure under, the Advisers Act" would undermine the current business model of broker-dealers.[95] In situations where the "business and legal risks are unmanageable, broker-dealers will withdraw from offering the affected products and services, which would disserve the interests of retail customers."[96] The undifferentiated extension of the current fiduciary standard also would significantly increase the costs associated with retail customers' accounts and consequently would reduce the affordability of advisory services, in SIFMA's opinion, as such an extension would reduce both options and access to certain products for retail investors.[97]

According to SIFMA, the optimal approach would be a new uniform standard that would prioritize and protect investors' interests and preserve the choice and access investors currently have. The new standard also would need to be capable of adapting to the different business models employed by broker-dealers and investment advisers, meaning that any standard enacted would be business-model neutral. Another guiding principle of SIFMA's approach would be that in the case of a material conflict of interest, the SEC should articulate ways for broker-dealers and investment advisers to provide clear and effective disclosures to customers in a manner which would comport with the new standard, and receive the customer's consent, if required.

With regard to disclosure, SIFMA suggests that customers may consent to a material conflict of interest, subsequent to mandatory disclosure by the broker-dealer or investment adviser. Not only should disclosures be required to be clear and concise, but SIFMA's position is that the SEC should also take a "layered approach to disclosure" in order to "provide retail customers with the clearest, most relevant information at the time it is most important to [the customers'] decision making, and therefore most likely to be read, with greater detail simultaneously made available to the customer if desired."[98] Any disclosure updates would be provided through an annual notification to customers, where such disclosures were deemed "necessary or appropriate."[99]

In articulating the new standard of conduct, under SIFMA's approach, the SEC necessarily would provide the "detail, structure and guidance necessary to enable broker-dealers to apply the fiduciary standard to their distinct operational model."[100] The success of the new standard of conduct will depend in important part upon the SEC's articulation of the scope of the obligations of broker-dealers and investment advisers, including but not limited to: 1) when the standard of conduct should commence;[101] 2) specification of the broker-dealer's obligations under the new standard in the customer agreement,[102] including but not limited to which disclosures are required and when such disclosures are required; 3) application of the uniform standard on an "account-by-account basis";[103] and 4) "inclusion of traditional product sales and compensation arrangements for broker-dealers."[104]

SIFMA further stated that while the current legal precedence and guidance pursuant to the Advisers Act still would apply to investment advisers, it would not apply to broker-dealers.[105] In particular, SIFMA noted that broker-dealers should continue to have the ability to engage in principal transactions under the new standard, as it was the intent of Congress to preserve this ability.[106]

The Institute

Contrarily, the Institute stated that "the rich history of law, policy and experience provides a backdrop for extending the fiduciary standard to brokers rendering personalized investment advice to retail investors."[107] The Institute calls into question SIFMA's aim to prioritize investors' interests by highlighting areas in which SIFMA's suggested framework seeks to "ensure that the fiduciary standards adopted by the SEC will fit broker-dealers' existing business practices and business models"[108] instead of promoting and protecting investors' interests. According to the Institute, the fact that SIFMA does not advocate for a modification or discontinuation of the products and services offered by broker-dealers to investors is problematic as SIFMA advocates the articulation of a new standard "without any corresponding change in the advice and recommendations that may be provided [to investors]."[109] In essence, the Institute takes issue with SIFMA's position that "suitable product recommendations suffice, and that a fiduciary 'due care' screening and investment selection process to meet the 'best interest' standard is not required"[110], as such a position is not consistent with putting investors' interests first.

With regard to conflicts of interests, the Institute's view of SIFMA's position is clear, stating that "at its core, SIFMA, it appears, unabashedly champions the benefits of conflicted advice."[111] Moreover, the Institute states that:

> "SIFMA's absolute and unconditional support of broker-dealers' ability to continue to have conflicts with customers' interests makes it hard not to conclude that SIFMA's (1) position is based more on the economic and business concerns associated with a fiduciary standard than on customers' best interests and (2) argument that customers interests would be harmed if broker-dealers decided not to provide certain products or services that involve conflicts of interest is based on the economic and business repercussions of imposing a true fiduciary standard on broker-dealers."[112]

The Institute takes issue with SIFMA's departure from the established and unambiguous view of the SEC that advisors are strongly urged to "avoid conflicts."[113] Furthermore, the Institute takes issue with SIFMA's position on required disclosures. The Institute argues that SIFMA's position with regard to disclosures, including flexibility and the layered approach discussed above, would favor broker-dealers, investment advisers and their employers, while undermining the best interests of customers. Moreover, the Institute states that it is "necessary, but not sufficient, under a fiduciary standard for a customer to provide informed consent to a conflict of interest" because even where consent has been obtained, "such consent does not obviate the need for the fiduciary to also determine that the proposed transaction is in the best interests of the client."[114]

SIFMA's position that the standard may apply on an account-by-account basis, as specified within the investor's contract, is also problematic for the Institute, as "the fiduciary duty may not be negotiated and contracted away or otherwise limited by contract."[115] Moreover, taking SIFMA's approach to the standard could, in the Institute's opinion, result in the switching of standards by broker-dealers without informing the customer that the switch is occurring, the reason underlying the switch and how the switch will affect the broker-dealer's relationship with the customer.[116]

Based upon the foregoing (in addition to the numerous other comment letters received by the SEC in response to its Study) it is clear that there is significant dissention among industry commentators and stakeholders as to whether a new standard should be adopted. Likewise, if a new standard is adopted, it is clear that there is significant dissention as to what the new standard should be, as well as the underlying reasons why various aspects of such a standard are crucial to industry stakeholders.

**VII. Other Considerations**

Safe Harbor Provisions

In the event a uniform fiduciary standard ultimately is imposed, it is unclear whether there would be a "safe harbor provision" put in place which would "insulate broker-dealers from any unforeseen consequences of a uniform fiduciary standard."[117] According to industry expert Donald B. Trone, any uniform standard, or alternatives thereto, likely would include a safe harbor provision as the vast majority of federal regulatory agencies have similar procedures in place.[118] The practical effect of a safe harbor provision would be that so long as a firm was able to prove it had complied with the safe harbor provisions set forth by the regulatory agency, it would be shielded from liability under the new regulation(s).

Based upon other safe harbor provisions in existing regulations, a safe harbor provision in the uniform fiduciary standard may resemble the following model:

1. For those who wish to serve in a fiduciary capacity, the firm must "define minimum qualifications (in terms of experience, licensing and training)"[119];

2. Advisors would be required to "accept and acknowledge his or her fiduciary status in writing"[120];

3. Advisors serving in an advisory capacity would be required to agree to "use only investment procedures, databases, software and technology approved by his or her firm"[121];

4. Advisors would be required to "agree to maintain records demonstrating their procedural prudence (the details of their decision making process)"[122]; and

5. The firm would be required to monitor the activities of the advisors.[123]

The above model is business-model neutral and is similar to "supervisory procedures already being followed by FINRA member firms and to procedures SEC-registered investment advisory firms should have in place."[124] While many in the industry would advocate the inclusion of a safe harbor provision in order to enable firms to limit their exposure to liability to the "conduct of the advisor and to the firm's oversight, supervision and monitoring"[125] of the registered representative or adviser, critics worry that a safe harbor provision would result in the client's interests not being prioritized. However, any firms not prioritizing client interests would arguably be "easy to spot" and consequently would be "at risk of losing their safe harbor insulation."[126]

<u>Effect of Heightened Duty on Dually-Registered Advisers</u>

Regardless of what form the uniform standard of conduct might take, if the SEC determines it will exercise its rulemaking authority and enact such a standard, dually-registered advisers may find it difficult to determine which standard should be applicable to them. The SEC indicated that it should be assumed, at least for purposes of the Request, that any rule which would be enacted "would not relieve an investment adviser who is also registered as a broker-dealer from its obligation to comply with Advisers Act Section 206(3) or the rules thereunder."[127]

Based upon the SEC's Request, it seems likely that if enacted, the new uniform standard, or alternative thereto, would serve as a baseline standard of conduct. Investment advisers may also be subject to any heightened requirements imposed upon them by the Advisers Act. If the standards were to conflict, this would indicate potential areas where harmonization would be necessary. However, practically speaking, the rule could specify that the investment advisers could default to whichever rule is more protective of the investor. It seems that any rule established would need to include guidelines for what to do in the event of an undiscovered conflict, while the body of law and precedence still was being developed.

<u>Department of Labor Fiduciary Investment Advice Re-Proposal</u>

On a related note, the Department of Labor ("DOL") is expected to issue a re-proposal of its definition of an "investment advice fiduciary" sometime during July 2013 as part of its "campaign to expose and minimize conflicts of interest in the retirement plan industry."[128]

Commentators have noted that the DOL re-proposal likely will be coordinated with the SEC's rulemaking regarding the potential imposition of a uniform fiduciary standard, or alternatives thereto, upon broker-dealers and investment advisers.[129] The DOL and the SEC may exercise their rulemaking authority at or around the same time, as both the DOL fiduciary re-proposal and the SEC's decision regarding whether it will implement a uniform fiduciary standard for broker-dealers and investment advisers are both expected in the second half of 2013.

Currently, under the Employee Retirement Income Security Act ("ERISA"), if an advisor provides investment advice, the advisor is "automatically deemed to be a fiduciary."[130] Under ERISA, an advisor provides investment advice and is consequently deemed a fiduciary if:

> (1) "such person renders advice to the plan as to the value or advisability of making an investment in securities or other property,
>
> (2) on a regular basis,
>
> (3) pursuant to mutual agreement or understanding (written or otherwise),
>
> (4) that such services will serve as a primary basis for investment decisions, and
>
> (5) that such person will render advice based on the particular needs of the pan."[131]

Importantly, "investment advice" is more narrowly defined under ERISA than under federal securities laws. If the DOL's re-proposal follows the changes set forth in its initial proposal on the definition of whether an advisor is providing fiduciary investment advice, it is expected that the definition will be broadened to include situations where there is "an understanding or agreement that the advice 'may be considered' in connection with a plan investment decision, regardless of whether it is provided on a regular basis."[132] Clearly, such a change could impose a fiduciary duty on advisors providing "casual or even one time investment advice."[133] However, under the current and proposed definitions, in order for an advisor to be deemed a fiduciary, the investment advice given must necessarily be "individualized advice for the particular plan client."[134]

It also is expected that the DOL re-proposal will include some form of a safe harbor provision where advisors may avoid fiduciary status by providing various "in your face" disclaimers to clients. While the DOL's initial proposal did not require these disclaimers to be in writing, it "clearly contemplated some type of notice or acknowledgement form for the plan client."[135] Essentially, in order to avoid fiduciary status, an advisor would need to state to his or her client(s) that the financial advisor is not "providing impartial advice."[136] It seems that any financial advisor who does not agree to making the appropriate disclosures and disclaimers to his or her clients may "be forced out of the retirement plan business."[137]

Due to the crossover of financial advisors who service retail investors as well as retirement plans, it is clear that any rules or guidelines imposed by the DOL will have a profound impact upon the entire financial services industry. Consequently, additional harmonization of industry rules and regulations likely will be required.

**VIII. Conclusion**

While the SEC repeatedly has stated that the various approaches and underlying assumptions included in its Request do not suggest the agency's policy view or the ultimate direction of any proposed action, it seems that the detailed approaches can fairly be taken as a fundamental core idea base upon which any policy or rulemaking may be formulated. Given the enormity of the task of changing the regulatory framework of the financial services industry, it is no surprise that the SEC effectively has taken two years to issue this Request.

Undoubtedly, the Request will foster much needed analysis and debate as to whether a heightened standard should be imposed upon broker-dealers and investment advisers, what sort of standard should be imposed and how the regulatory changes would affect the financial services industry, as a whole. Ultimately the fact that the rulemaking process will have taken several years both should benefit investors and put reasonable burdens on the financial services industry. ✦

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(Endnotes)

1 Securities and Exchange Commission's Request for Data and Other Information regarding the Duties of Brokers, Dealers and Investment Advisers ("SEC Request"), March 1, 2013, *available at* www.sec.gov/rules/other/2013/34-69013.pdf.
2 SEC Request p. 29.
3 Securities and Exchange Commission study on Investment Advisers and Broker-Dealers ("SEC Study"), January 2011, *available at* www.sec.gov/news/studies/2011/913studyfinal.pdf.
4 SEC Request p. 6.
5 SEC Request p. 1.
6 Brokers may be considered fiduciaries under certain circumstances and certain state laws. As a general matter, brokers have been found by courts to have fiduciary status when the brokers: "exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers" (SEC Request p.3 footnote 3). *See, e.g.*, *United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993); *MidAmerica Fed. Savings & Loan Ass'n v. Shearson/American Express Inc.*, 886 F.2d 1249, 1257 (10th Cir. 1989); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).
7 SEC Request p. 4.
8 SEC Request p. 5.
9 SEC Request p. 6.
10 SEC Request p. 25-29.
11 SEC Request p. 25.
12 *Id*.
13 SEC Request p. 26.
14 *Id*.
15 SEC Request p. 26.
16 SEC Request p. 27.
17 *Id*. Notably, if this assumption were included in any rule that was enacted by the SEC, harmonization with certain Financial Industry Regulatory Authority Inc. ("FINRA") rules currently in force likely would be required. In particular, FINRA Rule 2111, which sets forth FINRA members' duties regarding the suitability of investment recommendations and investment strategies for customers, includes a continuing suitability obligation after the provision of investment advice.
18 SEC Request p. 27.
19 *Id*.
20 *Id*.
21 SEC Request p. 29.
22 SEC Request p. 29.
23 SEC Request p. 25.
24 Importantly, the SEC stated in its Request that the potential standards and alternative approaches discussed are non-exclusive (see SEC Request p. 24).
25 SEC Request p. 29.
26 SEC Request p. 29, citing SEC v. Capital Gains Research Bureau, Inc.,375 U.S. 180, 194 (1963).
27 SEC Request p. 31.
28 *Id* at footnote 44.
29 SEC Request p. 31.
30 SEC Request p.32-34.
31 SEC Request p.32-33.
32 SEC Request p. 33.
33 *Id*.
34 *Id*.
35 *Id*.
36 *Id*.
37 SEC Request p. 34.
38 *Id*.
39 *Id*.
40 SEC Request p. 35.
41 SEC Request p. 35-36.
42 SEC Request p. 35.
43 *Id*.
44 SEC Request p. 35-36.
45 SEC Request p. 36.
46 *Id*.
47 *Id*.
48 SEC Request p. 37.
49 *Id*.
50 SEC Request p. 37-38.
51 SEC Request p. 38.
52 *Id*.
53 SEC Request p. 39.
54 SEC Request p. 40.
55 *Id*.
56 *Id*.
57 *Id*..
58 SEC Request p. 41.
59 *Id*.
60 *Id*.
61 Knut A. Rostad, *What Fiduciaries Should Be Reminded Of On Valentine's Day*, Investment News, at p. 12 (February 11, 2013).
62 Foundation for Fiduciary Studies, *Prudent Investment Practices: A Handbook for Investment Fiduciaries* ("Handbook") at p. 15 (2003).
63 *See* Rostad.
64 Handbook p. 15.
65 *Id*.
66 Handbook p. 23.
67 *Id*.
68 *See* Rostad.
69 *Id*.
70 *Id*.
71 *Id*.
72 Handbook p. 16.
73 *Id*.
74 *See* Rostad.
75 *Id*.
76 Mark Schoeff Jr., *FINRA's Broker-Comp Proposal Raises Hackles*, Investment News, *available at* www.investmentnews.com/article/20130305/FREE/130309958# (March 5, 2013).
77 *Id*.
78 *Id*.
79 *See* Rostad.
80 *Id*.
81 *Id*.
82 *Id*.
83 Handbook p. 30.
84 *Id*.
85 Comment Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association (July 14, 2011) ("SIFMA Letter") at p. 17 footnote 37, available at www.sec.gov/comments/4-606/4606-2952.pdf.
86 Id.
87 SIFMA Letter p.1, Introduction.
88 SIFMA Letter p. 5.
89 Id.
90 Id.
91 Id.
92 SIFMA Letter p. 11.

93 SIFMA Letter p. 14.
94 SIFMA Letter p. 11.
95 Id.
96 Id.
97 SIFMA Letter p. 14.
98 SIFMA Letter p. 20.
99 SIFMA Letter p. 22.
100 SIFMA Letter p. 15.
101 Id.
102 SIFMA Letter p. 17.
103 Id.
104 Id.
105 SIFMA Letter p. 15.
106 SIFMA Letter p. 23.
107
Comment Letter from Knut A. Rostad, President of The Institute for the Fiduciary Standard (April 9, 2012) ("Institute Letter"), at p. 4, available at www.sec.gov/comments/4-606/4606-2972.pdf.
108 Institute Letter p. 5.
109 Institute Letter p. 6.
110 Id.
111 Institute Letter p. 7.
112 Id.
113 Id.
114 Institute Letter p. 10.
115 Institute Letter p. 11.
116 *Id.*
117 Donald B. Trone, Standard Issue: What needs to be done to advance a fiduciary standard?, Financial Advisor Magazine p. 48 (January 2013).
118 *Id.*
119 *Id.*
120 *Id.*
121 *Id.*
122 *Id.*
123 *Id.*
124 Trone at p. 85.
125 *Id.*
126 *Id.*
127 SEC Request p. 34, footnote 48.
128 Marcia S. Wagner, *Broader "Fiduciary" Definition: Legal Update*, at p. 2, *available at* discover.byallaccounts.com/rs/byallaccounts/images/ERISA-Fudiciary-Definition-Legal-Update-WP.pdf.
129 Wagner p. 5.
130 Wagner p. 3.
131 *Id.*
132 Wagner p. 4.
133 *Id.*
134 *Id.*
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136 *Id.*
137 Wagner p. 6.

# Cybercrime and the Financial Industry

By Jennifer Woods Burke, CompliGuide LLC; Jill Fieldstein, Esq. contributed to the article.

Cybercrime is a growing global threat and cybercriminals are using increasingly sophisticated schemes to commit their crimes, making it difficult to detect, mitigate and combat security intrusions. Cybercriminals exploit weaknesses in technology infrastructure to accomplish their goals. Due to recent attacks on major retailers, individuals, financial firms and government agencies are focusing on our collective vulnerability to cybercriminals. In this article we will provide a general overview of the issues relating to cybercrime and the status of various regulatory initiatives on the subject.

**A. Federal Government Concern**

In a March 6, 2013 OP-ED piece in the Wall Street Journal, Michael McCaul, Sr., the U.S. Representative for Texas's 10th congressional district and Chairman of the House Committee on Homeland Security wrote "[c]yberwarfare is no longer an abstract threat to the homeland—it is happening now." [1] Citing to testimony provided to the House Committee on Homeland Security in 2012 by Stephen Flynn of Northeastern University, McCaul indicated that "[wh]en transformers fail, so too will water distribution, waste management, transportation, communications and many emergency and government services…[g]iving the average of twelve-month lead that is required to replace a damaged transformer today with a new one, if we had a mass damage of that scale at a local regional level the economic and society disruption would be enormous." He continues, asserting that "[n] ation states that mean America harm are sponsoring Cyber espionage and are targeting the fastest route to the country's most sensitive information and critical infrastructure: wireless networks."

According to Congressman McCaul, hacking attacks against the United States by criminals have been sponsored by other countries, with the majority of attacks involving China. For example, in recent years hacking events have occurred against a company that provided remote access to North America's oil and gas pipelines, the United States' Air Traffic Control system, major United States banks and also major United States retailers. In addition to this, it was recently reported in the Wall Street Journal that criminals launched an attack against a power sub-station supplying power to Silicon Valley.[2]

1 See http://homeland.house.gov/news/mccaul-op-ed-hardening-our-defenses-against-cyberwarfare-wall-street-journal

2 See Assault on California Power Station Raises Alarm on Potential for Terrorism, Rebecca Smith, February 5, 2014 (Wall Street Journal) available at:
http://online.wsj.com/news/articles/SB10001424052702304851104579359141941621778?KEYWORDS=assault+on+electric&mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052702304851104579359141941621778.html%3FKEYWORDS%3Dassault%2Bon%2Belectric

In addition to federal concerns regarding international espionage, cybercrimes aimed at the private sector appear to also be increasing. In April 2014 written testimony was provided to the House Committee on Homeland Security - Subcommittee on Cybersecurity by Secret Service agents wherein it was identified a "marked increase in the quality, quantity, and complexity of cybercrimes targeting private industry and critical infrastructure".[3] As detailed in the testimony, criminals are engaging cooperative efforts to accomplish cybercrimes such as "network intrusions, hacking attacks, malicious software, and account takeovers" and utilize "membership sites" to further these goals. These membership sites have created a virtual marketplace which allow criminals to, for example, buy, sell and trade malicious software and access networks, credit and bank card data, bank and brokerage account information and provide access to counterfeit identity documents. All of which should be of significant concern for financial institutions.

**B. SEC and FINRA**

The rise of cybercrime requires collaboration between the private sector and government and self-regulatory agencies to protect against future attacks. While financial firms are increasingly focused on ensuring that they have sufficient security controls, recent regulatory activity seems to indicate that regulators are concerned that not enough has been done by financial firms.

In January 2014, the SEC told a group of compliance professionals of its plan to ramp up its assessment of whether investment advisers have policies and procedures to prevent, detect and respond to cyberattacks and identity theft. As reported by Reuters, Jane Jarcho, the National Director for the SEC's investment adviser exam program, stated that the SEC is concerned about security risks that could arise from vendors having access to advisors' systems.[4] Jarcho stated that SEC examiners will be reviewing "policies on IT training, vendor access and vendor due diligence, and what information [firms] have on any vendors," as well as business continuity plans after cyberattacks. Moreover, Jarcho said that the examiners will be reviewing whether or not advisors are reporting "material" cyber events to the regulators.

3 See http://www.dhs.gov/news/2014/04/16/written-testimony-usss-house-homeland-security-subcommittee-cybersecurity-field.

4 See, Sarah N. Lynch, "SEC examiners to review how asset managers fend off cyber attacks," Reuters (Jan. 30, 2014), available at http://www.reuters.com/article/2014/01/30/us-sec-cyber-assetmanagers-idUSBREA0T1PJ20140130.

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The SEC is reportedly developing new rules related to the prevention and detection of cybersecurity concerns. However, based on Jarcho's statements on March 7, 2014 at the Investment Adviser Association's compliance conference, when cybersecurity rules are released small firms should not expect to be held to different standards of cybersecurity preparedness than large institutions.[5]

Further evidencing escalating concern over the issue, the SEC announced that it would host a roundtable on cybersecurity to be held at the Commission's office in Washington, D.C. on March 26, 2014.[6] In advance of the Roundtable, Commissioner Luis Aguilar stated that "… the roundtable will focus and foster thoughtful discussions on how SEC-regulated entities and public companies can best prepare for, and respond to, the inevitable cyberattack. Clearly, both market participants and issuers need to consider and develop appropriate preventive safeguards and they need to have adequate plans in place that will make it easier to quickly repair the damage of an attack."

Financial firms have been required to meet some of the issues attendant with cybercrime with the advent of Regulation S-P ("Reg S-P"). Since the promulgation of Regulation S-P in 2000, financial institutions – brokers, dealers, investment companies and investment advisors – have been required to adopt written policies and procedures that address safeguards for the protection of customer information and records. This includes protecting against any threats to the security of customer records and information, and against unauthorized access to or use of customer information.

In May 2013, the Identity Theft Red Flags Rule ("Reg S-ID") went into effect, with a compliance date in November 2013.[7] Reg S-ID requires firms to develop and implement written identity theft programs that are designed to detect identity theft "red flags" and prevent and mitigate such identity theft in connection with the opening of a covered account or any existing covered account.

While rules were promulgated, financial firms did not necessarily receive practical guidance on how to best prevent or prepare for a cyberattack. FINRA did provide some general guidance on identity theft, including a webpage dedicated to member firm identity theft protection.[8] Therein, FINRA provides a step-by-step reporting plan that member firms can follow if the firm's identity or that of one of its' registered representatives is believed to be employed in a scam, including reporting the alleged scam to a variety of regulators including the FBI, FINRA, SEC, CFTC, state regulator and the International Organization of Securities Regulators. FINRA also created a variety of Investor Alerts on the topic of cybercrime.[9] The topics include, but are not limited to, email phishing, cold call phone solicitations from brokerage firm imposters, fake regulator websites, investment scams after natural disasters and on-line job classifieds to steal personal information and identities.

In January 2014 both the SEC and FINRA indicated that cybersecurity would be an examination priority this year. Following these announcements, FINRA launched a Targeted Exam to assist the regulator in assessing ***whether*** and ***how*** its members are prepared to deal with the present and growing threat of cybersecurity attacks.[10]

FINRA's Targeted Exam Document and Information Request is lengthy and incredibly detailed, seeking information that could indicate that the regulator has expectations that its members are building defenses against potential cyberattacks that rival those developed by the most imaginative of Hollywood's script writers and directors. Firms were questioned on such topics as corporate espionage, international espionage and attacks on the national infrastructure. FINRA has not committed to affirmatively releasing the results of the examination request to develop best practices for its members. However, should FINRA do so, many firms are likely to face not only a steep learning curve on the issues, but also the fact they may have to commit formidable financial resources to install the expected and necessary defenses.

Following these events, on April 15, 2014 the SEC issued a Risk Alert on cybersecurity with Sample Examination Questions attached. Therein, it was revealed that approximately fifty (50) financial firms – broker dealers and investment advisors - will be examined for cybersecurity measures. The release of the sample request for documents and information in advance of the examination process appears to be an apparent attempt to provide firms with guidance on regulatory expectations. The Risk Alert can be found here http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf. .

## C. CONCLUSION

At this juncture, regulatory dialogue with financial firms on the subject of preparedness for a cyber attack has begun in earnest. Many firms will find after a review of FINRA's Targeted Exam and the SEC's Risk Alert that they will need to increase focus and resources on cybersecurity issues. This will necessarily require further involvement with and knowledge of the technology industry, which (outside of a few select vendors) few small firms likely have. However, should a significant cybercrime occur at a financial firm it could have the potential to cause economic disrupt if not disaster to the market place. Consequently, serious consideration should be given to what more a firm can do to bolster controls even in advance of the release of formal regulatory rules on the issue. ✦

### RESOURCES

**Resources available on the US Department of Homeland Security – United States Computer Emergency Readiness Team Site:**

**Security Organizations**

CERT Coordination Center

DHS Cyber Resources

Forum of Incident Response and Security Teams (FIRST)

Homeland Open Security Technology (HOST)

International Telecommunications Union, Cybersecurity Gateway

National Council of ISACs

National Cybersecurity and Communications Integration Center (NCICC)

Organization of American States, Cybersecurity Program

Organization of Economic Cooperation and Development, Working Party on Information Security and Privacy

Stop Think Connect™ (Department of Homeland Security)

5 See Financial Advisor Online SEC IA Exams Chief: Small Firms Won't Get Cyber Security Rules Exemptions, March 7, 2014 by Ted Knutson at http://www.fa-mag.com/news/sec-ia-exams-chief--small-firms-won-t-get-cyber-security-rules-exemptions-17205.html

6 See "Addressing Known Risks to Better Protect Investors", Commissioner Luis A. Aguilar, SEC Speaks, Washington, D.C. Feb. 21, 2014 at http://www.sec.gov/News/Speech/Detail/Speech/1370540828740#.UyiL1_ldVz4

7 To assist member firms, FINRA provides a template for an Identity Theft Program on its website at http://www.finra.org/Industry/Tools/P119095

8 See https://www.finra.org/Industry/Issues/CustomerInformationProtection/p117442

9 See https://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/p010734

10 General information regarding FINRA's January 2014 Targeted Examination Letter can be found at http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P443219

Stop Think Connect™ (National Cybersecurity Alliance)

**Vulnerability Information**

National Vulnerability Database (NVD)
Search U.S. government vulnerability resources for information about vulnerabilities on your systems.

Common Vulnerabilities and Exposures List (CVE)
Search vulnerabilities by CVE name or browse the US-CERT list of vulnerabilities for specific CVEs.

Open Vulnerability Assessment Language (OVAL)
Identify vulnerabilities on your local systems using OVAL vulnerability definitions.

National Infrastructure Advisory Council's Vulnerability Disclosure Framework

**Tools and Techniques**

Build Security In
Collection of software assurance and security information to help software developers, architects, and security practitioners create secure systems

Information Sharing Specifications
TAXII, STIX, and CybOX are technical specifications designed to enable automated information sharing for cybersecurity situational awareness, real-time network defense and sophisticated threat analysis.

National Institute of Standards and Technology (NIST)
NIST offers Security Practices as well as Special Publications.

Center for Education and Research in Information Assurance and Security (CERIAS)

Operationally Critical Threat and Vulnerability Evaluation (OCTAVE)

**Research and Guidelines**

Build Security In

DHS Cybersecurity R&D Center

National Institute of Standards and Technology Special Publications

Software Assurance: Community Resources and Information Clearinghouse

Education

Federal Cyber Service: Scholarship for Service Program (SFS)
The SFS program seeks to increase the number of skilled students entering the fields of information assurance and computer security.

National Centers of Academic Excellence in Information Assurance Education
The Centers of Academic Excellence program strengthens higher education in information assurance programs to meet America's growing requirements for cybersecurity professionals.

**Security at Home**

OnGuard Online
Provides practical tips from the Federal Government and technology industry to help consumers guard against Internet fraud, secure their computers, and protect personal information.

Stay Safe Online
Sponsored by the National Cybersecurity Alliance (NCSA) to promote safe behavior online

The NetSmartz Workshop
Educational resource material for children and teens

Stop Think Connect™
A national public awareness campaign aimed at increasing the understanding of cyber threats and empowering the American public to be safer and more secure online.

**Information Sharing and Analysis Centers (ISACs)**

Information Sharing and Analysis Centers (ISACs) were established to allow critical sectors to share information and work together in an effort to protect our critical infrastructures and minimize vulnerabilities.

**Banking and Finance**
Financial Services ISAC

**Emergency Services**
Emergency Management and Response ISAC

**Energy**
Electricity Sector ISAC

**Government**
Multi-State ISAC

**Information Technology**
Information Technology ISAC

**Real Estate**
Real Estate ISAC

**Research and Education**
Research and Education Networking ISAC

**Telecommunications**
National Coordinating Center for Telecommunications (NCC)

**Transportation**
Surface Transportation ISAC

**Water**
Water ISAC

**Policy and Government**

US-CERT Year In Review CY 2012

US-CERT 2012 Trends In Retrospect

Bottom-Up Review Report

Comprehensive National Cybersecurity Initiative

E-Government Act of 2002 including Title III - The Federal Information Security Management (FISMA) Act
The purpose of this Act is to enhance the management and promotion of electronic government services and processes. Title III of this act is the Federal Information Security Management Act of 2002. The E-Government Act permanently supersedes the Homeland Security Act in those instances where both Acts prescribe different amendments to the same provisions of the United States Code.

IT Sector Baseline Risk Assessment
The ITSRA identifies and prioritizes national-level risks to critical functions delivered and maintained by the IT Sector and relied on by all critical infrastructure sectors. It validates the resiliency of key elements of the IT Sector's infrastructure and highlights strategies to address risks to enhance the resiliency and security of the IT Sector.

National Infrastructure Protection Plan

National Strategy to Secure Cyberspace
This document outlines an initial framework for both organizing and prioritizing efforts to protect against disruptions to our critical information systems and reduce vulnerabilities to cyber threats. The Department of Homeland Security's National Cyber Security Division (NCSD) has been charged with coordinating the implementation of the strategy.

Office of Management and Budget Guidance on FISMA
The subject of this memorandum is Reporting Instructions for the Federal Information Security Management Act and Updated Guidance on Quarterly IT Security Reporting.

Presidential Homeland Security Issues
This web page describes the Presidential guiding principles for securing the United States from 21st-century threats.

Quadrennial Homeland Security Review

# New Members

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- Industry changes

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Please see our website (www.nscp.org) for submission guidelines under the Publications tab.


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