2014: A New Era in Securities Supervision and Compliance Developments

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Introduction

2014 brought a new era of securities regulation, with the changing of the guard at the Securities and Exchange Commission ("SEC") during 2013, and the appointment of Mary Jo White as Chair. The SEC made clear that 2014, the year of the organization's 80th anniversary, would feature stricter enforcement, increased examinations and a continued focus on creating and implementing cultures of compliance and disclosure throughout the industry. The Financial Industry Regulatory Authority, Inc. ("FINRA"), a self-regulatory organization ("SRO") regulated by the SEC, similarly promulgated guidance reflecting a focus on compliance, supervision and disclosure. As detailed below, the regulatory changes and guidance issued by the SEC and FINRA provide a comprehensive overview of important compliance developments throughout 2014, as well as a roadmap for the future of regulation in the securities industry.

Regulatory Developments and Guidance

a. Status of Fiduciary Standard for Registered Representatives Still Unclear

In the SEC's annual Agency Financial Report ("Agency Report"), the SEC noted that it has proposed or adopted 90% of the rules required by the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[1] which was signed into law more than four years ago. The Dodd-Frank Act gave the SEC the discretion to determine whether to hold registered representatives of broker-dealers to a fiduciary standard, the standard applicable to investment advisers pursuant to the Investment Advisers Act of 1940.

In an effort to increase the stability and transparency of the financial system, the SEC stated in its Agency Report that one of its priorities in 2015 is to evaluate whether to apply a "uniform fiduciary standard of conduct for investment advisers and broker-dealers when providing personalized investment advice to retail investors about securities", as well as "ways to better harmonize the regulatory requirements

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of investment advisers and broker-dealers when they are providing the same or substantially similar services to retail investors."[2] While the SEC did not specify a firm deadline, it did indicate that it would consider the aforementioned issues prior to the end of the 2015 fiscal year, which ends on September 30, 2015.[3]

The Department of Labor ("DOL") also has stated that it plans to revise a proposal that would expand its definition of fiduciary under the Employee Retirement Income Security Act ("ERISA") in January 2015. In the original proposal, the DOL indicated it would expand the definition of a fiduciary to include "financial advisers who provide advice to retirement plans, including brokers who sell individual retirement accounts" with the goal of promoting investor protection by preventing conflicts of interests.[4] Industry experts expect the DOL's proposal to be highly controversial, as a result of the widespread and costly effect any amendments would have on the industry.[5] The DOL has indicated that the January proposal will address rollovers, as abuse in rollovers is a primary concern of the White House.[6]

The Securities Industry and Financial Markets Association ("SIFMA") has been one of the top lobbyists against the DOL's expansion of the definition of a fiduciary.[7] SIFMA believes the DOL's proposal would force individual retirement accounts ("IRA") to "be held only in managed accounts that charge investors fees based on assets under management."[8] That would "curtail their being offered in brokerage accounts that charge investors on a transaction basis for trades."[9] The net effect, from SIFMA's perspective, would be that registered representatives of broker-dealers would be prevented from servicing small accounts, causing harm to the industry as well as investors.[10] However, the DOL repeatedly has stated that the new proposal would not prohibit commissions on IRAs and would include "other exemptions that would address other forms of compensation."[11]

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While it remains unclear what heightened standard, if any, the SEC and/or the DOL may impose, firms can expect that any changes to the applicable standard will result in increased compliance costs for the financial services industry. If a uniform fiduciary standard is imposed, the industry will be forced to adapt to an entirely new regulatory regime.

b. Crowdfunding: States Take Matters into Their Own Hands

In the absence of regulatory action by the SEC regarding crowdfunding, certain states have taken matters into their own hands in an effort to preempt any SEC regulations and benefit from the growing crowdfunding industry. Crowdfunding, which is a "method of collecting many small contributions by means of an online funding platform to finance or capitalize a popular enterprise," has been in the spotlight since the Jumpstart Our Business Start-ups Act ("JOBS Act") was signed by President Obama in 2012.[12] The JOBS Act purportedly was intended to "open up the capital markets and create jobs by loosening regulations on initial public offerings and allowing for crowdfunding."[13] Certain portions of the JOBS Act pertaining to crowdfunding were hotly contested by the SEC, as the organization worried the crowdfunding provisions would provide additional avenues to defraud the investing public. To curtail the SEC's concerns, a provision was inserted into the bill which would require companies trying to raise more than $500,000 to provide selected audited financial statements.[14]

Congress had instructed the SEC that the organization had until December 2012 to enact the new crowdfunding rules contained in the JOBS Act.[15] More than two years after the December 2012 deadline, the SEC has issued a proposal and a request for comment. The SEC received comments as recently as November 2014, so it is possible that the organization may take regulatory action in the coming year. Business owners are anxious for the SEC to issue crowdfunding rules so that they may benefit from the JOBS Act provisions. Currently, entrepreneurs can only raise capital via an equity stake in the

company from accredited investors.[16] Non-accredited investors may contribute to crowdfunding campaigns in exchange for gifts only, not equity in the venture.[17]

In the meantime, some states have utilized a regulatory loophole and promulgated their own crowdfunding rules. The Securities Act of 1933 provides that when an offering is made in a state by a company from that state, the offering is exempt from the federal rules on securities offerings.[18] That provision allows states to maintain jurisdiction over securities offerings contained within the state's borders.[19]

Surprisingly, many states that have enacted crowdfunding rules do not seem as concerned with the potential for fraud. For example, Texas, Michigan and Indiana have enacted rules that require neither audited financials nor extensive disclosures.[20] Specifically, Texas has no annual filing requirements and allows companies to raise up to $1 million annually, so long as the companies pass muster after being examined by a privately-run portal.[21] Most recently, Oregon issued a crowdfunding proposal that would cap a company's total fundraising at $250,000, with a $2,500 cap per investor.[22]

Critics of the SEC's position on crowdfunding note that the strict requirements favored by the organization would be costly, possibly consuming more than 15% of the offering, which would restrict the effectiveness of crowdfunding. While it remains to be seen whether the individual states or the SEC will "get it right," all can agree that crowdfunding has the potential to be an invaluable resource for small businesses who traditionally have few opportunities for access to capital. Nonetheless, advisors should counsel clients to exercise caution when considering investments via crowdfunding sites, as the potential for fraud must be thoroughly vetted.

c. The Volcker Rule and Dodd-Frank

Considered to be one of the toughest requirements in the Dodd-Frank Act, the Volcker Rule mandates that banks are prohibited from proprietary trading activities and restricts commercial banks and their affiliates from investing in hedge funds and private equity, along with various other restrictions.[23] There is, however, an exception carved out for banking activities considered to be "systemically important," as that term is defined in the legislation. Certain asset classes also are exempt from the Volcker Rule, most notably U.S. Treasury securities and municipal securities.[24] The Volcker Rule regulations were adopted in December 2013, and banks have been given a deadline of July 21, 2015 by which they must comply with those regulations.[25]

As a result of the stringent requirements in the Volcker Rule, U.S. regulators recently decided to ease some of those requirements, and the central bank decided to extend the July 2015 deadline for implementing the Volcker Rule to July 2017.[26]

Further, the Office of the Comptroller of the Currency is considering an exemption for small banks and small financial firms from the legislation.[27] Many small institutions have argued that since they did not have a role in much of the activity that led to the 2007-2009 financial crisis, they should not be subject to the harsh and costly restrictions of the Volcker Rule.[28] Eliminating smaller institutions from the Volcker Rule's requirements would decrease the cost of compliance with industry regulations for those firms while maintaining Congressional intent, which was to "to prevent big banks from making risky trades that could threaten financial stability."[29]

Some critics, such as SIFMA, are concerned about the Volcker Rule's potential to reduce market liquidity, which would in turn increase risk and volatility.[30] Other critics worry that the Volcker Rule does not go far enough in protecting the financial stability of the market. Specifically, the rating agency Standard & Poor's ("S&P") has noted that the banking subsidiaries of firms such as Goldman Sachs and Morgan Stanley are still "too big to fail."[31]

The most significant reform to the Dodd-Frank law to date is a provision embedded in the 1,603 page Congressional spending bill released in early December 2014 which would "loosen the terms of the prohibition of derivatives trading by bank branches supported by the federal safety net."[32] As a result, greater responsibility will be placed on regulators to "demonstrate they have effective oversight of bank activities of the sort that played a role in the 2008 financial crisis."[33] Specifically, Section 716 of the Dodd-Frank Act previously required banks that engaged in un-cleared credit default swaps to "place them in separate affiliates with higher capital requirements" so that the swaps "would not be funded through the deposit gathering activities of banks, seen as an important lesson from the financial crisis."[34]

While it is unclear what additional changes will be made to the Dodd-Frank legislation in the coming year, under the current political and regulatory environment, it is probable that the industry will see more loosening of regulations.

d. New Supervision and Compliance Obligations for Municipal Advisors

The MSRB's New Rules

In November 2014, the Municipal Securities Rulemaking Board ("MSRB") adopted rules aimed at the supervision and compliance obligations of municipal advisors, after receiving approval to do so from the SEC. The MSRB was charged with regulating municipal advisors pursuant to the Dodd-Frank Act, prior to which municipal advisors were loosely regulated.[35] The majority of the rule changes become effective April 23, 2015. One year after the rule changes take effect, and on an annual basis each year thereafter, executives of municipal advisor firms will be required to certify in writing that the firm has created and implemented processes "to establish, maintain, review, test and modify written compliance procedures."[36]

The MSRB's new rules regarding supervision are intended to "help firms prevent, [...] promptly detect and address any compliance issues."[37] Specifically, Rule G-44 confers upon municipal advisors an "explicit obligation to effectively supervise their personnel in the interest of promoting compliance with all regulatory requirements."[38] However, due to the fact that municipal advisors encompass a wide array of business types and activities, Rule G-44 is "intended to be a 'principles based approach to supervision and compliance' that accommodates 'the diversity of the municipal advisor population, including small and single-person entities.'"[39] To that end, the new rules allow municipal advisors to tailor supervisory procedures to "account for their size, business model and advisory structure" and also grant "significant latitude […] to advisors who operate as sole proprietorships."[40] To accommodate Rule G-44, the MSRB also amended the record keeping requirements under Rules G-8 and G-9.

Examination of Municipal Advisors by the SEC

The MSRB's new rules took effect on July 1, 2014. Shortly thereafter, in August 2014, the SEC announced that it would initiate a two-year examination program in order to ensure municipal advisors' compliance with the new supervision and compliance rules.

The SEC's examination initiative will include "focused and risk-based examinations of municipal advisors registered with the SEC but not with FINRA",[41] and will occur in three phases. First, the National Examination Program ("NEP"), overseen by the SEC's Office of Compliance Inspections and Examinations ("OCIE"), will reach out to the newly registered municipal advisors and inform them of their obligations under the new rules. Second, the NEP will examine selected municipal advisors' compliance programs in one or more identified risk areas. Third, the NEP will report its findings to the SEC.[42] The OCIE has highlighted registration, fiduciary duty, disclosure, fair dealing, supervision, books and records, and training/qualifications as the risk areas that may be included in the examinations.[43]

The SEC will review the information gathered during the examinations to identify compliance and supervision pitfalls, as well as to inform future rulemaking and regulatory guidance. While no specific guidance has been issued as to how municipal advisors will be selected for examination, OCIE has indicated that it plans to examine a "significant percentage" of newly registered municipal advisors.[44]

FINRA: Notable Rules and Regulatory Notices

a. FINRA's New Consolidated Supervision Rules

FINRA recently adopted new rules pertaining to the supervision of member firms and their registered representatives, as set forth in Regulatory Notice 14-10. The rules below incorporate many of the supervisory requirements under the existing rules of the National Association of Securities Dealers ("NASD") and New York Stock Exchange ("NYSE") but also impose certain new supervisory requirements.[45] The new rules, which took effect December 1, 2014, also codify and expand upon certain regulatory guidance promulgated in prior years.

FINRA Rule 3110

FINRA Rule 3110 continues to require that member firms "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."[46] FINRA Rule 3110(a)(4) requires the designation of one or more appropriately registered principals in each of a member firm's office of supervisory jurisdiction ("OSJ") but now also requires the "designated principal of an OSJ to have a physical presence, on a regular and routine basis, at each OSJ for which the principal has supervisory responsibilities."[47]

FINRA Rule 3110 now creates a presumption against a single individual acting as principal for multiple OSJs, as was previously allowed. Firms still may designate a single principal for multiple OSJs, so long as the firm considers and documents various factors evidencing the reasonableness of the firm's decision to do so. In light of the presumption against a single individual acting as principal for multiple OSJs, if a firm decides to take that course of action, it should carefully monitor that individual in order to keep itself apprised of any changes and also should document its supervision of that individual. In terms of a firm's obligation to document its supervision, FINRA Rule 3110(b) now requires firms to make various changes in their written supervisory procedures. Firms will need to review and update those procedures accordingly.

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One of the most notable changes to the supervision rules under FINRA Rule 3110 is that supervisors no longer are allowed to supervise themselves. For firms that have relied on this "self-supervision" model, the new prohibition will be a stark change. There is a limited exception pursuant to FINRA Rule 3110(b)(6)(c) in situations where "compliance is not possible because of the member's size or a supervisory personnel's position within the firm."[48] If a firm plans to take advantage of this exception, the firm must "document the factors considered by the firm in determining that compliance with the new requirements [is] not possible."[49] The firm also must "document how the supervisory arrangement with respect to the affected supervisory personnel nonetheless complies with the requirement that the firm's supervisory system be reasonably designed to achieve compliance with all applicable legal and regulatory requirements."[50]

In Regulatory Notice 14-10, FINRA expressed its position that "one-person OSJ locations where the on-site principal engages in sales-related activities that trigger OSJ designation should be subject to focused reviews because of the possible conflicts of interest that may arise."[51] As a result, FINRA intends to closely monitor one-person OSJs to determine whether the individuals are supervised adequately.[52] Accordingly, financial firms that have not yet created procedures for heightened supervision and/or focused inspections of one-person OSJs should do so. Firms that do not already have procedures calling for heightened or focused inspections of such locations should consider adopting them.[53]

Additionally, proposed FINRA Rule 3110(e) would require each member to "ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the member applies to register that applicant with FINRA and before making a representation to that effect on the application for registration."[54] The proposed rule also clarifies that a firm is "required to review a copy of an applicant's most recent Form U5 if the applicant previously has been registered with FINRA or another self-regulatory organization."

FINRA Rule 3120

Consistent with prior requirements, FINRA Rule 3120 requires firms to "designate and identify to FINRA one or more principals who must establish, maintain and enforce a system of supervisory control policies and procedures" in order to "test and verify that the firm's supervisory procedures are reasonably designed […] to achieve compliance with applicable securities laws and regulations and FINRA rules."[55] Where necessary, FINRA Rule 3120 also requires members firms to create additional or amended supervisory procedures.[56] FINRA Rule 3120 mandates that an annual report be submitted to senior management containing various details. For firms with more than $200 million or more in gross revenue, the new rule now requires additional information to be included in the annual report that is submitted to senior management.

FINRA Rule 3150

Prior to FINRA Rule 3150, there were strict limits imposed on a firm's ability to hold mail for its customers. Those restric-

tions have been eliminated by the new rules, which now allow firms to hold mail subject to certain conditions including, but not limited to, written instructions from the customer.

b. CARDS: Comprehensive Automated Risk Data System Proposal

First announced in late 2012, FINRA recently re-issued its highly controversial Comprehensive Automated Risk Data System ("CARDS") proposal. The proposal would allow FINRA to collect customer account information, account activity and security identification information from firms on a standardized, automated and regular basis.[57] In Regulatory Notice 14-37, FINRA provided an overview of CARDS, noting that CARDS is "intended as the next step in the evolution of FINRA's risk-based surveillance and examination programs."[58]

Despite FINRA's assurances regarding the benefit of CARDS, many in the financial industry are critical of the proposal. SIFMA has stated that FINRA lacks the statutory authority to move ahead with CARDS and that the data collection plan "is an attempt to diagnose a regulatory ill without appropriately accounting for the impact on investor privacy and civil liberties."[59] SIFMA is concerned that CARDS will "infringe upon investors' right to privacy by mandating that brokerage firms turn over to FINRA all individual account information on a monthly basis" as this would result "in the creation of a centralized database of all individual brokerage accounts, updated monthly and held by a quasi-governmental entity."[60] SIFMA also has expressed concerns regarding cyber security, calling CARDS a "prime target for hackers."[61]

CARDS would occur in phases and the first phase would require the approximately 200 carrying/clearing firms to "periodically submit in an automated, standardized format specific information that is part of the firms' books and records relating to their securities accounts and the securities accounts for which they clear."[62] During phase two, "fully disclosed introducing firms" would be required "to submit specified account profile-related data either directly to FINRA or through a third party."[63]

Although FINRA expects phase one to cost between $390,000 and $8.3 million per firm, SIFMA disagrees. SIFMA retained IBM to conduct a comprehensive cost-benefit analysis of CARDS, and IBM estimates that phase one of CARDS would cost the industry $680 million to build and $360 million in annual, ongoing maintenance.[64]

As the comment period just recently expired on December 1, 2014, FINRA has yet to issue any guidance as to the future of the CARDS proposal but will likely do so during the 2015 fiscal year. In the interim, one can expect industry critics to continue to fight the proposal and attempt to find less costly and invasive alternatives.

Consolidated Audit Trail

The SEC adopted Rule 613 to "create a comprehensive consolidated audit trail ["CAT"] that would allow regulators to efficiently and accurately track all activity throughout the U.S. markets in National Market System ("NMS") securities."[65] Rule 613 requires that the self-regulatory organizations (SROs) jointly submit an NMS plan "to create, implement and maintain a consolidated audit trail."[66]

Industry critics are concerned about the implementation costs and difficulties, as well as the potentially duplicative effect of implementing CAT and CARDS at the same time. FINRA has addressed those concerns by attempting to distinguish CARDS from CAT, stating that "only limited overlap exists between the CARDS and CAT data sets" and "CAT would not collect information regarding customer risk tolerance, investment objectives, money movements, or position data that FINRA uses to conduct its reviews."[67] However, FINRA's response has been criticized as falling short of fully addressing industry concerns. Specifically, "many of the same Operations, Technology and Compliance staffs would have to be involved, and the same internal systems would need to be modified or drawn upon for both efforts," which has led to "concerns about internal capacity to execute both projects effectively at the same time."[68]

Conclusion

Two rule proposals are on the table which arguably will define whether a new era of regulation is upon us. Depending upon how the final versions materialize, changes to the Volcker Rule and the broader Dodd-Frank legislation, as well as the CARDS proposal, stand a good chance of transforming the securities industry.

Meanwhile, the SEC and FINRA can take credit for implementing new supervision rules. The SEC's approval of the MSRB's rule proposals for supervision and compliance, and FINRA's new consolidated supervision rules, have and will continue to have an impact.

What remains on the SEC's plate, of course, are two significant rule initiatives: fiduciary duty status for registered representatives, and crowdfunding. The securities industry would welcome the comfort associated with knowing whether and if so, how, a fiduciary duty standard will be implemented. Likewise, the capital markets and the securities industry would be well served by a national set of rules and regulations for crowdfunding, as opposed to the piecemeal, state-by-state activities that thus far have transpired.

ENDNOTES

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42 *Id* at Footnote 36.

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45 Importantly, this article will not provide an exhaustive list of the new supervisory requirements.

For a full overview of the new consolidated supervision rules, firms and registered representatives should thoroughly review the rules described herein, as well as any additional corresponding regulatory notices and/or notices to members.

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