BDWEEK

Regulatory news and compliance best practices.

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■ INSIDE...

What to brace for in 2012? Compliance pros weigh in

Wondering what's in store for 2012 for broker-dealers on the compliance front? Here are some views from compliance pros who offered their predictions:

✔ **Lisa Roth,** the CEO/CCO of **Keystone Capital Corporation** in San Diego, and a member of **FINRA's** Small Firm Advisory Board:

"Implementing the new suitability rules will be job one for many firms. I expect to see the final FINRA rules for supervision in 2012, and I am guessing that we will find out more about IA oversight (I wager FINRA will be the SRO) in 2012."

✔ **Paul Tyrrell**, partner, Boston office of **Bingham**, and a former senior special regional

(Predictions, continued on page 2)

Factors regulators look at to help determine a firm's risk revealed

Officials at the **SEC** and **FINRA** increasingly have been talking about plans to examine firms based on risk, and pushing for firms to have robust risk-management practices. Here's a look at just some of the factors regulators look at to determine whether a firm's risk level warrants the firm being scrutinized closer, according to **Jackie Hallihan**, director and partner at **Ascendant Compliance Management**. The list came from speakers at a recent Ascendant event.

✔ **A significant change in business activities** — An example would be a traditional broker-dealer that suddenly gets involved in micro-cap stocks, or a bond firm that gets involved in the penny-stock business, said **John Walsh**, a partner in the Washington office of **Sutherland Asbill & Brennan**, and a 23-year veteran of the SEC who played a key role in creating the SEC's Office of Compliance Inspections and

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Enforcement Alert

Procedures need to address how firm will follow up on reps' suspect trades

Make sure your firm's written supervisory procedures specify how it will follow up and act on problems that are revealed during reviews of reps' trades. One Boston-based firm's failure to do that resulted in a rep being allowed to trade excessively, **FINRA** says.

Under a settlement reached last week, FINRA fined **Detwiler Fenton & Co.** $40,000 for supervisory failings related to that shortfall, as well as for other violations, including:

✔ having a system that allowed commissions to be paid over 5%;

✔ having a system that didn't detect unauthorized discretionary trading; and

✔ failures related to the firm's Customer Identification Program.

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Predictions *(cont. from pg. 1)*

counsel in FINRA's Boston District Office:

From an examination focus, compliance professionals should look at the two, recently issued exam alerts, Tyrrell said. One was issued by the **SEC** and deals with the master-sub account trading model, and priorities with respect to examining those types of accounts. "That's certainly a signal that going into 2012, the examination staff of the SEC and FINRA will be looking at those types of account relationships with more scrutiny."

The other alert — a joint one issued by the SEC and FINRA — focuses on branches, firms' branch inspection programs, and how branches are treated in terms of their risk assessments and firms' ability to audit and control what's happening in them.

In addition, Tyrrell said, "One certainly would expect to see FINRA continue to be active in certain product types. In particular non-traded REITS seem to be getting a lot of play of late, and certainly going into 2012 we are likely to see more in this space."

In addition, the suitability rule that takes effect in July 2012 is something that examiners will be focused on, Tyrrell noted.

He also expects regulators to focus on firms' handling of social media used by employees.

"I think that's an area where we're likely to see continued and perhaps renewed focus by examiners. As firms widen their use of social media, the likelihood of failures in terms of maintaining and retaining the particular media could generate enforcement cases in this area as well," Tyrrell said.

✔ **Brian Rubin**, a partner in the Washington office of **Sutherland Asbill & Brennan**, and a former Deputy Chief Counsel with FINRA's Enforcement Department:

"The **SEC's** upcoming decision in the **Theodore Urban** case will have a huge impact on broker-dealers and investment advisers. That case involves whether Mr. Urban (the general counsel of a broker-dealer) was a supervisor of a registered representative who did not report directly to him and whether Mr. Urban acted reasonably in supervising that representative who committed fraud. It will affect how general counsels provide advice to firms and how other 'non-line supervisors,' such as compliance officers, perform their jobs. Prior to this action, the SEC has rarely charged 'non-line supervisors' with being responsible for the conduct of another person. The SEC's theory in this case creates a 'target-rich environment' for the SEC to go against other general counsels and compliance officers."

✔ **Amy Lynch,** president of **FrontLine Compliance LLC**, a regulatory compliance consulting firm based in Leesburg, Va. and New York, and a former member of FINRA's Enforcement Department.:

"(1) The new suitability rule (2111) will be the biggest challenge next year. The compliance date of 7/9/2012 is still too soon for most firms since there is a real challenge with the transaction-by transaction suitability requirement. (2) Continued restricted compliance budgets throughout 2012 will stress compliance departments that will be forced to

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Predictions *(cont. from pg. 2)*

do more with less and less. (3) More SEC oversight exams will occur in 2012. Firms may be used to seeing FINRA on a regular basis, but they will also start seeing SEC examiners in their offices which will increase the pressure on compliance."

✔ **Duane Thompson**, president of the legislative and media strategy consulting firm **Potomac Strategies**, and a former managing director of the **Financial Planning Association**:

"(1) [The] SEC will propose a uniform fiduciary standard for brokers and advisers providing personalized investment advice in late spring 2012; it will be sued in federal court by the insurance industry after the rule is adopted; (2) The Department of Labor will re-propose a fiduciary definition in early spring 2012, little changed from the earlier proposal; it, too, will be sued by industry opponents after the final rule is adopted. (3) Rules to harmonize broker/investment adviser regulation will not be proposed by the SEC in 2012. (4) A bill to create a self-regulatory organization for investment advisers will pass the House but not the Senate in 2012. The bill will be re-introduced in the 113th (new) Congress in 2013. (5) [The] effective date for disclosure of fees and fiduciary status for plan service providers under DoL's new rule 408(b)(2) will be delayed from April 1st to Oct. 1st."

✔ **Diane Golbeck**, a Port Orchard, WA attorney, and a former FINRA examiner:

"My number one concern on behalf of my clients is the extraordinarily intrusive and seemingly endless examinations and informational requests that are essentially paralyzing the firms and causing them to be distracted from their own initiatives and day-to-day work. While we can all recognize that there are firms out there that do not put the client's interests first or that are purposely taking advantage of unsophisticated investors, I hold firm to the belief that most firms are full of good people that try hard to do good work for their clients and comply and try to stay current with ever-changing rules and regulations."

"It goes without saying that if a regulator digs hard enough into any firm, which they now seem to be doing with regularity, they will find some process or procedure that can be improved or that doesn't stand up to the test of 100% compliance. This is NOT the standard; rather it is whether there is reasonable implementation and compliance and I strongly advocate firms speaking up, pushing back, and challenging 'de minimis'-type findings, as well as maintaining good record-keeping of the frequency and breadth of regulatory requests and examinations."

✔ **Deborah Meshulam**, partner in the Washington office **of DLA Piper**, and a former Assistant Chief Litigation Counsel of the SEC's Enforcement Division:

"(1) Branch office supervision — consider the recent joint SEC/FINRA guidance; (2) Large Trader Reporting — new rules going into effect for broker-dealers on April 30, 2012 —monitoring requirements; (3) Marketing to seniors — FINRA Notice to Members 11-52 — this is an ongoing issue and I expect focus on this area; (4) Private offerings — always a hot topic; (5) Reg SHO — lots of focus on short sales, **UBS** $12 million fine."

✔ **Buddy Doyle**, founding principal and managing director of **Oyster Consulting**, and a former senior vice president at **Wachovia Securities, LLC**:

"Each firm will have its own concerns based on size, business model and whether it is clearing, self-clearing or an introducing firm. That being said, Oyster has been focused on helping clients get ready or respond to a number of issues including:

"FINRA Rules 2090 and 2111 (know your customer and suitability rule) implementation will be a hot topic within broker/dealers as firms try to determine how to move from a transactional based analysis to suitability of a strategy and hold recommendation."

"15c3-5 – the BD Access Rule will have long-term ramifications on how firms implement and use controls for algorithmic trading, API's EMS and OMS' going forward."

"The Series 99 registration of operations personnel will certainly have an impact on certain individuals in our industry. Many long-term operations personnel will be taking a test for the first time in a long while."

"I think there will be a lot of focus on market transparency and trade reporting with the TRACE

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Predictions *(cont. from pg. 3)*

changes and the recent OATS NMS implementation. Firms will need to be sure they have adequate procedures to ensure trades are reported correctly. It sounds easy, but the number of potential scenarios and outcomes for trades make this complicated."

"CFOs and FINOPS will be worried about the new amendments to rule 17a-5. FORM Custody and the FOCUS reporting will be heavily scrutinized because of recent failures. It will be important for firms to have good procedures to be sure when you put your name on something, that it is accurate." ■

FinCEN instructs on how to fill out a SAR for an account takeover

The Treasury Department's **Financial Crimes Enforcement Network** wants to make sure you know how to fill out a Suspicious Activity Report correctly when you suspect that cybercriminals are trying to take over some of your customers' accounts.

The network noted last week that such criminals are increasingly using sophisticated ways to break into customer accounts. Their techniques include the use of malware, SQL injection attacks, spyware, Trojans, and worms.

The attacks are aimed at getting into a customer's account and, often, getting seemingly legitimate access to another customer's account.

A couple of signs that this might be happening include sudden wire transfers or sudden changes to customer and account profiles. Other signs are unusual ATM activity and clustered Automated Clearing House transactions in different geographic areas, FinCEN said.

When reporting on a SAR that you suspect that an account is being taken over, FinCEN says 💻 to consider the following:

✔ Use the term "account takeover fraud" in the narrative section of the SAR and describe the activity in detail.

✔ If the takeover involves computer intrusion, check the box on the SAR for "computer intrusion." In addition, you can check the "other" box and put "account takeover fraud" in the space that's provided.

✔ If the account takeover involves other activities such as telephone banking or use of social networks such as Facebook, you can check the "other" box and note "account takeover fraud," and put a short description of additional information in the space that's provided.

✔ If it involves wire transfer, in addition to selecting the "other" box and noting "account takeover fraud," you should check the box for "wire transfer fraud."

✔ If it involves Automated Clearing House transactions, check the "other" box and write in "account takeover fraud — ACH."

✔ If the takeover involves unauthorized access to PINs, account numbers and other identifying information, you might need to also check the box for "identity theft" in addition to selecting the "other" box and noting "account takeover fraud." You also might need to check other boxes, as appropriate.

Tips for protection

To help guard against takeovers, you need a sound red flag program, and a layered approach for protecting the customer, said a senior security officer at a national financial services firm who commented on condition that he not be identified.

Use multi-factor authentication for accounts access. The senior security officer said user names and passwords are too weak and almost useless against a motivated adversary.

Consider whether the users accessing your system are "captive," which would be employees, or not (customers you have little control over), the senior security officer said.

"For customers, there are technologies that use certificates that are installed on your computer when you first establish an account," he said.

To successfully authenticate, the customer needs a certificate that's located on the computer, as well as a password and user name.

If the customer tries to authenticate without a certificate, he or she is presented with about five security-challenge questions that must be answered correctly. If those are answered correctly, the customer gets a certificate on that computer and would log in the usual way in the future from that

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Account takeovers *(cont. from pg. 4)*

computer.

Another approach is to use a log-in system that sends a code to the customer's cell phone, the senior security officer said.

When the customer logs in with the user name and password, a text is sent to that phone with a security code that must be entered before getting access to the application. That system work's "great" unless the phone's battery is dead or the customer left their cell phone at home, he said.

For employees, you can use soft tokens that present a code every 20 seconds that needs to be entered when authenticating, the senior security officer said. ■

Risk *(cont. from pg. 1)*

Examinations. Regulators are likely to ask: "Are they supervising the new business? Are they familiar with it?" Walsh tells *BD Week*.

✔ **Media risks** — This refers to press reports that regulators see that raise questions about the firm's operations.

✔ **Previous exam results —** A firm's failure to address problems identified in an earlier exam could spur regulators to assign a higher risk level to that firm. **Note:** The SEC has made clear that it wants to increase the number of occasions when examiners interview firms' senior-level officers. Failure to address earlier exam findings could result in examiners wanting to interview members of a firm's board, if there is a board.

✔ **Data at the SEC —** Walsh mentioned that an example would be the recently announced Aberrational Performance Inquiries, which analyze data according to proprietary risk analytics (*BD Week*, Dec. 12, 2011). The SEC Enforcement Division's Asset Management Unit uses that method to evaluate hedge fund returns. The division's director, **Robert Khuzami**, recently said, "We're using risk analytics and unconventional methods to help achieve the holy grail of securities law enforcement – earlier detection and prevention. This approach, especially in the absence of a tip or complaint, minimizes both the number of victims and the amount of loss while increasing the chance of recovering funds and charging the perpetrators."

✔ **Third-party tips, complaints, referrals** — Signs of risk could come through the SEC's new consolidated database of tips, complaints, and referrals — which centralizes this information from areas from around the country.

✔ **Compensation** — Walsh noted that a few years ago there were recruitment campaigns where reps were offered "spectacular compensation" to change firms. But the goals they were expected to meet could be very high. This could pose a risk because, "What would an individual have to do to meet the goals?" Walsh asked. Similar concern can arise if there are contests for selling certain products, or other special compensation, he said. In August 2009, Commission Chairman **Mary Schapiro** sent an "Open Letter" to firms' CEOs, expressing concern about the big inducements firms were offering reps and reminding the CEOs about their firm's supervisory responsibilities with respect to sales practices.

✔ **Disciplinary actions** — A history of disciplinary problems at the firm, or a new event, could play a role in the firm being deemed risky.

✔ **Length of time since last exam** — The risk level could move up if it has been many years since a firm has been examined, or if the firm never has been examined. Forty percent of investment advisers have never been examined, according to testimony that OCIE Director **Carlo di Florio** gave to Congress last month.

✔ **Financial concerns** — Capital issues could certainly put a firm on the risky list. FINRA, of course, is looking at FOCUS reports. There are already coordinated reviews going on when it comes to looking at both the BD and the IA side of regulated firms. Ascendant partner **John Gentile** expects that in the future, there will be more joint exams involving bank examiners working with BD examiners when the BD is part of a bank. "I just think that this sort of dovetails with this whole concept of enterprise management because if the bank is in trouble, the BD and the IA are going to be in trouble," said Gentile, a former Assistant Regional Director of the SEC.

✔ **U.S. or foreign regulators** — Information about the firm from other regulators, including those in other countries, also comes into the mix. ■

Detwiler *(cont. from pg. 1)*

Between September 2006 and September 2009, Detwiler's WSPs called for weekly and monthly active trade reviews by its retail supervisor and its CCO, respectively, according to the Dec. 20 settlement. But those procedures didn't detail how the firm would follow up on potential concerns raised by those reviews, FINRA said.

As a result, a rep whom FINRA identified only as "CR" was allowed to trade excessively in the accounts of at least two retail customers during 2007 and 2008. This occurred even though the CCO's monthly trade reviews identified high levels of trading by "CR" in those accounts on multiple occasions, FINRA said.

Commissions

Detwiler's supervisory system to monitor commissions that were charged to retail customers also was found difficult to use effectively, FINRA said. It said that made it tougher to detect excessive commission.

Before 2008, when the firm first started providing a commission percentage on trade runs, the reviewing principal had to calculate commission percentages for each trade manually or mentally during the review.

Between September 2006 and September 2009, principals failed to use clearing firm exception reports that gave information such as when a broker had manually overridden the commission schedule, the settlement said. Also, the firm's commission schedules for equities and options set base commission and surcharges for a number of low notional value transactions at above 5%.

Among other findings:

✔ In 2005, the firm told reps it would cease using fee-based discretionary accounts. It told them that any broker who wanted to use discretion in a retail customer account would have to transfer the account to the firm's affiliated investment adviser. But the firm failed to establish adequate WSPs to spot brokers who continued exercising discretion in retail accounts on the BD side. As a result, "CR" continued to exercise discretion without written authority.

✔ From May 2007 through September 2009, the firm failed to obtain information required by its CIP, such as a driver's license or passport, to verify the identities of 22 customers. Fourteen of them were outside the U.S.■

Skip week

BD Week is taking its scheduled break. The next issue of *BD Week* will be e-mailed on Jan. 6, 2012.■

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