

SECURITIES LAW ALERT

OCTOBER 2009

FINRA Member Regulation Provides Insight Into Focus Areas

On Tuesday September 15, 2009 at the SIFMA Compliance and Legal Division luncheon held at the Harvard Club in Manhattan, guest speaker Michael Rufino, Senior Vice President and Deputy of FINRA Member Regulation, discussed several major issues on which FINRA will focus in the coming year. This information may serve as a valuable guide for firms in considering updates to their policies and procedures to remain in compliance with FINRA rules and regulations. ■

Member Reg Focus To Include Foreign Corrupt Practices Act (FCPA) and Anti-Money Laundering (AML)

Member Regulation will be focusing on the FCPA and on AML in the fourth quarter of this year. Examinations will pay particularly close attention to firms' policies and procedures, supervisory structure, training of staff, AML policies and procedures, correspondence (including email), and overall firm compliance with FCPA and AML policies and procedures. Member Regulation will focus on when FCPA reviews are conducted, who conducts them, how those reviews are documented and what internal control procedures firms have in place. Gifts and entertainment expenses will be a continuing area of scrutiny. ■

FTC Red Flag Rule

The Red Flag Rule (16 C.F.R. 681 (2007)) requires creditors and financial institutions to develop written plans to prevent and detect

identity theft. The Fair and Accurate Credit Transaction Act ("FACT Act") of 2003, requires that firms establish guidelines designed to prevent, detect and mitigate identity theft.

Exams will focus on firms' identity theft policies and procedures, which may be incorporated into their Reg S-P compliance. Particular attention will be paid to firms' use of consumer credit reports and other materials containing personally identifiable non-public information, as well as firms' policies and procedures for customer address changes related to debit and credit cards. FINRA staff has developed and published materials to help explain what types of entities are covered, and how firms might develop their identity theft prevention programs. Further guidance regarding the Red Flag Rule is provided in Regulatory Notice 08-69 which is available at: <http://www.finra.org/Industry/Regulation/Notices/2008/P117449> and in the July 27, 2009 podcast available at: <http://www.finra.org/Industry/Education/OnlineLearning/Podcasts/index.htm>. A template for identity theft programs is available through the FINRA website at <http://www.finra.org/Industry/Issues/CustomerInformationProtection/p118480>. ■

Annual Branch Office Inspections

Branch inspections will focus on ensuring that firms implement and maintain effective supervisory and control systems in keeping with the requirements of Rule 3012. This review will include whether firms have designated one or more principals to enforce their supervisory

control policies and procedures and whether they maintain a *bona fide* supervisory control program (including procedures for supervising the use of social networking sites as detailed below). ■

Specific Reviews for Specific Situations

Rufino emphasized that FINRA will continue to exercise flexibility in its priorities and will undertake specific reviews as situations may merit. However, in light of recent high profile fraud cases, FINRA examinations will focus on the integrity of financial statements, whether due diligence is being properly conducted by or with respect to feeder funds, whether firms are properly segregating financial control duties and whether firms are properly conducting third-party verifications.

FINRA examinations will more closely scrutinize financial statements and financial analysis, with particular emphasis paid to material misstatements, outside auditors, fraud issues and off-balance sheet items. Regarding feeder funds, FINRA will examine the relationships between member firms and their affiliates and will more closely scrutinize financial documents, financial disclosures, control relationships, conflicts of interests, the accuracy and extent of due diligence, appropriateness of trade recommendations and the legitimacy of investment strategies.

Although FINRA will evaluate the segregation of duties within a firm on a case-by-case basis, firms should be aware that, in FINRA's view, red flags are raised when one person or group controls the firm as a whole. Additional focus will be paid to pre-exam work, evaluation of material control relationships, implementation of policies and procedures and whether a firm

conducts independent tests to detect fraud. Lastly, third-party verification is a point of emphasis that will be evaluated on a case-by-case basis. This is an area that FINRA is looking to make more robust and FINRA will be evaluating clearing firms, custodial relationships, depositories, and may extend to customers. ■

Sweeps

FINRA conducts sweeps with the dual purposes of investigation and information gathering. Sweeps that FINRA is now conducting include municipal gas bonds and retail municipals. The gas bond sweep is examining whether official statements are being delivered to customers within twenty-five days of initial issuance, communication of material information to customers (and firm documentation that customers are receiving information), pricing of bonds, marketing and advertising and customer complaints. The retail municipal sweep is focusing on firms with a high number of retail transactions, however, Member Regulation also will continue to focus on various other aspects of retail municipal transactions.

In addition to current sweeps, firms should be aware that FINRA may perform sweeps in the near future relating to firms' placement of securities on watch lists, adherence to their own procedures (Rule 3012 testing), testing and documentation of firm procedures, employee and proprietary trading and the provision of accurate information to FINRA. ■

Pandemic Preparedness (Rule 3510)

In response to the outbreak of the H1N1 Flu, FINRA has made pandemic preparedness

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a particular point of emphasis. Firms should establish policies and procedures concerning pandemic preparedness, and make testing, assessing and communicating with employees about their policies and procedures an important focus in the upcoming year. In a recent study, firms expressed concern with absenteeism and telecommunication issues in the case of a significant medical event, and FINRA seeks to assist and educate members by providing planning resources. Information regarding pandemic preparedness can be found at FINRA's website at <http://www.finra.org/Industry/Issues/BusinessContinuity/P119937>. ■

Continuing Education Redesign

FINRA's continuing education programs have undergone a multi-year, multi-phase redesign, incorporating regulatory and firm elements. FINRA will be rolling out Series 101, 107 (Series 6 and 7) testing and attempting to create a more personalized, robust learning experience. With regard to content, FINRA will now provide four testing modules, with individuals permitted to choose the order in which they participate in the testing modules. Additionally, FINRA will be rolling out Series 201 testing in the fourth quarter of 2009. ■

Supervision of Social Networking Sites

FINRA realizes that social networking sites, including Facebook, Twitter and MySpace, are the wave of the future, and firms should be aware that they are expected to supervise their employees' use of this media. Many firms already block access to such sites. Though not specifically addressed in NASD Notice to Members 07-30 (available at <http://www.finra.org/Industry/Regulation/Notices/2007/PO19297>), firms should be aware that the principles concerning communications generally are equally applicable to social networking sites. Firms have the responsibility to capture, retain and supervise employees' use of these sites, and firms should be cognizant that regulators will focus on compliance in these three areas. ■

Complaint Trends (Quarterly)

Variable annuities were a continued area of concern due to apparent poor communication of information to customers. Rufino noted that 20% of FINRA sales practice complaints in the last quarter were annuities-related. ■

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