

June 23, 2008

FINRA Spring Securities Conference

The Financial Industry Regulatory Authority (FINRA) recently held its first-ever Spring Securities Conference in Hollywood, Florida, featuring senior FINRA officers, staff members and outside speakers who discussed a variety of industry issues and regulatory developments. The conference, traditionally hosted by the National Association of Securities Dealers, Inc. (NASD) on an annual basis, is the first Spring Securities Conference hosted by FINRA, which was created in July 2007 by the consolidation of NASD and the member regulation operations of the New York Stock Exchange (NYSE). This Alert presents some of the highlights from the conference and includes, where appropriate, background discussion, information from the conference materials and links to relevant resources.

Although a wide range of issues were discussed at the conference, certain key subjects were discussed repeatedly. Those subjects included:

- **Rulebook Consolidation.** At the fall 2007 securities conference, FINRA officials were hopeful that the consolidated rulebook would be complete by the end of 2008. However, at this conference, FINRA officials were far less optimistic. FINRA officials warned that it will likely take “a period of years” for the consolidated rulebook to be complete, blaming the delay, in part, on what is expected to be a prolonged comment and approval process. Nonetheless, there has been some progress. A few weeks ago, FINRA proposed consolidated rules for supervision, financial responsibility, books and records, and investor education. In addition, FINRA submitted a filing with the SEC to incorporate NASD’s marketplace and procedural rules into the consolidated FINRA rulebooks without substantive change.
- **The Credit Market Crisis.** The credit market crisis was, not surprisingly, a topic of frequent discussion at the conference as regulators and industry members alike are continuing to grapple with the causes of the crisis and its effects on the markets. The conference devoted a separate panel session to the credit market issues, which discussed, among other things, lessons from the crisis. Several other sessions also discussed issues relating to the crisis. Most notably, the fallout from the credit market crisis was reflected in FINRA’s enforcement and examination priorities, which were discussed in the session called, “Disciplinary Process I: Investigations Panel Session and the FINRA Examination Program Plenary Session.”

Summarized below are the remarks provided at the conference by senior FINRA officers and a senior SEC officer, and the discussions of several panel sessions. For ease of reference, a table of contents containing links to relevant sections of the Alert has been included. To view the text of a particular section, simply click on the corresponding page number in the table of contents.

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I. Remarks by Senior Regulatory Officials

The welcome remarks for the conference were provided by Marc Menchel, the Executive Vice President and General Counsel of Regulation at FINRA's Office of General Counsel. He introduced the conference's keynote speaker, Erik Sirri, Director of the SEC's Division of Trading and Markets. In addition, Mary Schapiro, FINRA's Chief Executive Officer, also provided remarks at the conference. Summaries of these remarks are provided below.

A. Marc Menchel's Remarks

Mr. Menchel focused his remarks on FINRA's ongoing efforts to consolidate the rulebooks of NASD and the NYSE. Mr. Menchel noted that FINRA recently published for comment consolidated rules in the areas of financial responsibility, supervision, books and records, and investor education. In addition, FINRA recently filed with the SEC a proposal to move NASD's marketplace rules (Rule 4000 through 8000) and procedural rules (Rules 8000 through 12000) into the new FINRA rulebook without substantive change. The marketplace rules cover regulatory requirements and fees for quoting, trading, reporting, clearing and comparing over-the-counter (OTC) transactions in Regulation NMS stocks, OTC equity securities and certain debt securities. The procedural rules generally govern FINRA investigations, disciplinary proceedings, arbitrations and mediations.

Despite the recent progress, Mr. Menchel indicated that the rulebook consolidation process will take "a period of years" to complete due to the comment and rule approval process. Mr. Menchel noted that the comment process almost always results in amendments to proposed rules, citing Rule 2821 as an example. Rule 2821 was initially proposed in 2005. After more than 1,200 comment letters and several amendments, portions of Rule 2821 finally became effective in early May 2008. The process is still ongoing, and FINRA recently proposed new amendments to Rule 2821 (discussed in the Insurance Products Regulation section below). Given that the approval process is expected to be lengthy, Mr. Menchel stated that FINRA would be proposing consolidated rules piecemeal.

B. Erik Sirri's Keynote Address

Mr. Sirri discussed four primary issues: (1) Regulation NMS; (2) Regulation SHO; (3) regulation of credit rating agencies; and (4) lessons from the credit market crisis.

(1) Regulation NMS

Mr. Sirri stated that Regulation NMS is "working well" and that transparency is at "an all-time high." Indeed, over 80% of trading volume occurs in transparent markets. The Order Protection Rule, one of the most debated aspects of Regulation NMS, is also "working very well." In addition, it has had an interesting side-effect—certain Electronic Communication Networks (ECNs), including Direct Edge, have declared their intentions to register as national securities exchanges so that they can be eligible for a protected quote in the consolidated quote stream.

(2) Regulation SHO

Mr. Sirri provided an update on rulemaking efforts relating to Regulation SHO. The grandfather clause has been eliminated from Regulation SHO, and the staff has proposed to eliminate the options market maker exception as well. In addition, the SEC removed the "tick test" from Regulation SHO and related rules. Initially, the removal of the "tick test" garnered little attention; however, after the credit market crisis, the media began to question whether the elimination of the "tick test" contributed to volatility. Mr. Sirri dismissed that speculation, stating that volatility increased around the world, not just in the U.S., so the volatility was not due to the elimination of the "tick test."

(3) Regulation of Credit Rating Agencies

In the wake of the credit market crisis, the SEC will be enhancing its regulation of credit rating agencies. Mr. Sirri noted that the SEC was granted rulemaking authority over credit rating agencies just two years ago by the Credit Rating Reform Act of 2006. However, Mr. Sirri emphasized that the SEC's rulemaking authority was carefully circumscribed. Importantly, the SEC does not have authority over the substance, methods or processes that credit rating agencies use to make their rating determinations. Instead, the SEC was granted authority to prescribe rules relating to, among other things, conflicts of interest and information rating agencies must disclose about themselves and their ratings. Mr. Sirri agreed with Congress' determination not to grant the SEC authority over the processes credit rating agencies use to formulate their ratings, noting that the SEC could not possibly review and pass judgment on the agencies' complicated algorithms.

Last year, the SEC promulgated its first round of rulemaking pursuant to its authority under the Credit Rating Reform Act. Mr. Sirri stated that a second round of rulemaking is forthcoming. The new proposed rules will require, among other things, that credit rating agencies disclose more information about the methodologies they use to determine their ratings. In addition, Mr. Sirri indicated that there is a "good chance" that the rules will address rating symbols (e.g., AAA) and possibly propose a different set of symbols for structured finance vehicles.

(4) Lessons from the Credit Market Crisis

Finally, Mr. Sirri directly addressed the credit market crisis. He cited the collapse of Bear Stearns, noting that on March 10 its liquidity was at \$18 billion, but by March 13 its liquidity was down to \$2 billion. Mr. Sirri admitted that he could not explain why it happened, but he could explain what happened. He likened it to the "classic run on the bank" caused by a collective loss of faith in the bank. He identified two important lessons from the crisis. First, the crisis highlighted the importance of robust valuation processes. Firms that invested in valuation technologies and developed their own valuation processes fared much better in the crisis than firms that did not. Second, the crisis underscored the importance of liquidity. There was a fundamental misunderstanding in the industry regarding the liquidity of certain instruments.

C. Mary Schapiro's Remarks

Ms. Schapiro's remarks centered on three issues: (1) the credit market crisis; (2) the Blueprint for Regulatory Reform; and (3) FINRA's ongoing consolidation efforts.

(1) Credit Market Crisis

Ms. Schapiro noted that in light of the credit market crisis, FINRA has heightened its surveillance of certain firms. FINRA staff reached out to certain firms to discuss liquidity and related issues. In addition, FINRA staff conducted special examinations of firms that played significant roles in the subprime market. It has become clear to FINRA that certain firms' risk management systems broke down.

(2) Blueprint for Regulatory Reform

Ms. Schapiro addressed the report entitled, "Blueprint for Regulatory Reform," recently published by the Treasury Department. Ms. Schapiro described the report as "startling," but agreed that the existing regulatory structure is unable to deal with crises because it is "fractionalized," and there is no regulator surveilling the overall market. Ms. Schapiro therefore supported the underlying goal of the Blueprint—improving the existing regulatory system. In addition, she praised the report for recognizing the importance of self-regulation.

(3) FINRA's Ongoing Consolidation Efforts

Ms. Schapiro stated that FINRA has made “substantial process” in integrating NASD and the member regulation operations of the NYSE. She highlighted FINRA’s success in consolidating the exam process, as well as FINRA’s recent strides in working towards a consolidated rulebook, including FINRA’s recent proposal of consolidated rules governing supervision, financial operations, books and records, and investor education. She admitted that the rulebook consolidation process has proven to be “amazingly complex.” Accordingly, FINRA will be proposing rules in “tranches,” and the industry should expect a “steady stream” of proposed rules over the next year. FINRA would like to complete the consolidated rulebook within the next 18 months; however, the time frame will depend on the volume and nature of the comments received from the industry.

II. General Sessions

There were two general sessions open to everyone who attended the conference. The first was the Examination Program Plenary Session where senior executives from Member Regulation and Market Regulation discussed the exam program. The second was the “Ask FINRA Staff” panel where senior staff answered anonymous questions.

A. FINRA Examination Program Plenary Session

This session featured FINRA’s two Executive Vice Presidents of Member Regulation, Robert Errico and Grace Vogel, and FINRA’s Executive Vice President of Market Regulation, Thomas Gira. Mr. Errico oversees FINRA’s sales practice examinations. Ms. Vogel heads FINRA’s Department of Risk Oversight and Operation Regulation, which conducts ongoing surveillance and annual examinations of financial and operation compliance, risk management and supervision. Mr. Gira is responsible for FINRA Market Regulation, which conducts ongoing market surveillance for, among other things, best execution, trade reporting, OATS reporting, Regulation NMS compliance, market manipulation, fraud, short sales and order handling.

The panelists discussed (1) the examination process, (2) sweep exams, and (3) examination priorities for 2008.

(1) Examination Process

The panelists provided an overview of the examination process. Among the issues highlighted were:

- **Exam Cycles.** The panelists discussed the exam cycles for financial operations exams, sales practice exams and Market Regulation exams. Financial operations exams are conducted on an annual basis. Sales practice exams are conducted on one-year, two-year or four-year cycles. The cycle that applies to a particular firm is based on FINRA’s risk-based analysis of the firm. According to Mr. Errico, approximately 100 firms are “Level 1 firms” subject to the one-year cycle. Market Regulation also uses a risk matrix to determine exam cycles and generally selects large firms, based on trading volume, for examinations.
- **Consolidated Exams.** Ms. Vogel stated that if a firm has a financial operations exam and a sales practice exam scheduled for the same year, FINRA will conduct both exams jointly at the same time. There will be a single request for documents and information, a single contact person (called the Administrative Lead), a joint exit meeting and a joint report summarizing FINRA’s findings. In addition, Mr. Gira indicated that approximately 80% of Market Regulation’s examinations are eligible for consolidation.

- **Request Letters.** Prior to an exam, FINRA sends a written request for documents and information to the member firm. The panelists agreed that this letter provides a roadmap of the issues FINRA intends to review during the onsite exam. The panelists encouraged firms to contact their Administrative Lead with questions or concerns about the request letter. In particular, if firms are unable to provide the documents or information requested, they should contact their Administrative Lead as soon as possible.
- **Examination Dispositions.** FINRA strives to provide firms with a report summarizing its examination findings within 60 days of the end of the exam. The firm has 30 days to respond to the report. Mr. Gira described the firm's response as "critical." Within 60 days, FINRA will issue a disposition letter. Possible dispositions include: no action, a letter of caution or a referral to Enforcement.
- **Overlap with SEC Exams.** Ms. Vogel indicated that FINRA receives copies of the SEC's examination reports and has an ongoing dialogue with the SEC regarding exams. Ms. Vogel acknowledged that the SEC often examines a firm right after FINRA completes its exam. While this is "burdensome" to the firm, Ms. Vogel stressed that FINRA cannot control when the SEC performs its exams. In fact, the SEC frequently examines a firm after a FINRA exam because the SEC is overseeing FINRA and wants to test FINRA's performance, as well as the broker-dealer's performance.

(2) Sweep Exams

Mr. Errico stated that the purpose of sweep exams is for FINRA to find out about industry practices. Ms. Vogel indicated that FINRA sweep exams are often motivated by market events or by FINRA's desire to test compliance with a new rule or regulation. Sweep exams are approved by a FINRA committee. Sweep exams are usually conducted by Member Regulation and sometimes by Enforcement. Mr. Errico noted that FINRA now publishes redacted sweep letters on its Web site.

To view redacted request letters from recent sweep exams, please click [here](#).

(3) Examination Priorities for 2008

The panelists took turns identifying the priorities for their respective examination programs.

(a) Sales Practice Exams

Mr. Errico identified the following priorities for sales practice examinations:

- Sales to seniors;
- Anti-money laundering;
- Protection of customer information;
- Business continuity plans; and
- Email retention and accessibility.

(b) Financial Operations Exams

Ms. Vogel articulated the following priorities for financial operations exams:

- Following up on the prior year's examination findings;
- Net capital calculation and the reconciliation of expense accounts;
- Subprime valuation, margin calls and reverse repos;
- Auction rate securities valuation; and
- Compliance with Regulation SHO.

(c) Market Regulation Exams

Mr. Gira stated that Market Regulation's main examination priority is Regulation NMS, which went into full effect last year. Market Regulation will be reviewing a firm's policies and practices relating to Regulation NMS compliance.

B. Ask FINRA Staff

Conference participants were provided with the opportunity to ask anonymous questions of FINRA senior officials. Below are summaries of some of the more interesting issues raised during this session.

- **Proposed FINRA Supervision Rules.** Mr. Menchel stated that FINRA is proposing to delete current Rule 3012's requirement relating to the supervision of a producing manager's customer account activity, including the requirement to impose heightened supervision when a producing manager's revenues exceed a certain threshold. Under recently proposed FINRA Rule 3110(b)(6), firms must have procedures prohibiting supervisors from supervising their own activities, or from reporting to, or having their compensation or continued employment determined by, someone they are supervising. In addition, firms must prevent such supervision from being lessened due to any conflicts of interest that may be present, including conflicts resulting from compensation the supervisor derives from the supervisee.
 - To view all of FINRA's proposed supervision rules, please click [here](#).
- **FINRA's Cooperation Policy.** Susan Merrill, Executive Vice President and Chief of Enforcement, stated that FINRA is working internally on crafting a Regulatory Notice that sets forth FINRA's policy on awarding credit for cooperating with investigations. Currently, FINRA's Sanction Guidelines apply to all investigations; however, the relevant NYSE Information Memorandum continues to apply to NYSE cases.
- **Proposed Rule on Dispositive Motions.** Linda Fienberg, President of FINRA Dispute Resolution, stated that FINRA recently proposed a rule restricting the ability of a respondent to file a motion to dismiss before the claimant presents his or her case-in-chief. FINRA is currently reviewing comments submitted on the proposed rule and will discuss with the SEC which comments warrant a response.
- **Proposed Business Entertainment Rule.** FINRA staff indicated that FINRA recently proposed its third amendment to the business entertainment rule. Among other things, the amendment limits the proposed rule's detailed recordkeeping requirement for entertainment involving representatives of institutional accounts. The SEC appears to be distressed by this proposed change and concerned that FINRA has weakened the rule.
- **New Variable Product Advertising Guidelines.** Thomas Selman, Executive Vice President of FINRA Investment Companies/Corporate Financing, stated that FINRA expects to publish within the next few weeks proposed guidance relating to communications with the public concerning variable

products. Mr. Selman noted that the existing guidelines were created in the 1990s and need to be modernized.

- **Updates to Written Supervisory Procedures.** Ms. Vogel indicated that a firm should update its procedures when regulations change or when the firm's business changes (e.g., when the firm introduces a new product). Further, she encouraged firms to "get ahead" of rules by paying attention to FINRA notices and current events. Ms. Merrill stated that FINRA usually brings enforcement actions when firms "totally missed the boat" on a particular issue, not when firms take too long to update their procedures.

III. Panel Sessions

This section provides highlights from many of the conference's panel sessions. The panel sessions covered in this section include: (a) Disciplinary Process I: Investigations; (b) Disciplinary Process II: Adjudications; (c) Insurance Products Regulation; (d) Advertising Regulation; (e) Supervisory Controls; (f) Broker-Dealer and Investment Adviser Issues; (g) Credit Market Issues; (h) Fixed Income Compliance; (i) Anti-Money Laundering: Use of SARs; and (j) Small Firm Compliance.

A. **Disciplinary Process I: Investigations**

This panel discussed (1) the lifecycle of a FINRA investigation, and (2) FINRA's enforcement priorities.

(1) The Lifecycle of a FINRA Investigation

The panel discussed five stages of FINRA's investigation process: (a) opening of the investigation; (b) requests for documents and information; (c) deciding whether to bring charges; (d) the settlement process; and (e) litigation.

(a) Opening of the Investigation

James Shorris, Executive Vice President and Executive Director of Enforcement, indicated that the genesis of investigations differs depending on whether the investigation is conducted by a regional office or FINRA's home offices.¹

(i) *Investigations by FINRA's Regional Offices*

Mr. Shorris explained that a significant percentage of investigations are initiated by FINRA's regional offices. The sources of these investigations are FINRA examination findings (including both cycle exams and cause exams). Accordingly, investigations initiated by the regional offices are the product of coordination between Member Regulation and Enforcement. Mr. Shorris indicated that cause exams, which are usually based on customer complaints, regulatory filings or tips, generate more investigations than cycle exams. Ms. Merrill indicated that over 90% of cause examinations result in an Enforcement referral, while "very few" cycle exams, approximately 15%-20%, result in Enforcement referrals. Given that exam findings can result in Enforcement investigations, a panel member who is in the industry stressed the importance of initiating a dialogue with the examiners early in the process.

¹ FINRA's home offices include NASD's former home office in D.C. and the NYSE's former principal office in New York.

(ii) *Investigations by FINRA's Home Offices*

A smaller percentage of investigations are conducted by FINRA's home offices. Mr. Shorris indicated that the home offices usually handle the larger, "more complex" cases that span many regions. Investigations by FINRA's home offices can be self-generated (e.g., based on information the staff reads in the newspapers) or can be based on tips, regulatory filings, arbitration claims or litigation claims.

(b) Requests for Documents and Information

The panelists addressed the following two issues relating to FINRA requests for documents and information: (1) overly burdensome requests; and (2) requests for documents and information beyond required books and records.

(i) *Overly Burdensome Requests*

The panelists discussed what a firm should do if it receives a Rule 8210 request for documents or information that is overly burdensome. The industry panelist recommended that a firm receiving such a request contact FINRA staff as soon as possible to discuss the firm's concerns. Mr. Shorris stressed that firms should not wait to contact the staff until the day before the response is due.

(ii) *Requests Beyond Required Books and Records*

The panelists also discussed that FINRA sometimes requests documents or information beyond the books and records firms are required to maintain under NASD rules and the federal securities laws. For example, FINRA sometimes requests that firms produce data that is not maintained in the course of its regular business. Such requests have been the source of some frustration for the industry. Ms. Merrill stated that FINRA has the authority to issue such requests under Rule 8210 because it requires members and associated persons to provide "information," not just books and records.

(c) Deciding Whether to Bring Charges

The panelists discussed three processes that relate to FINRA's determination regarding whether to bring disciplinary charges: (1) FINRA's sufficiency of the evidence review; (2) the Wells process; and (3) the new Disciplinary Advisory Committee (DAC) review process. In addition, the panelists provided certain statistics regarding how often FINRA investigations result in formal disciplinary actions.

(i) *Sufficiency of the Evidence Review*

Mr. Shorris explained that FINRA reviews the sufficiency of the evidentiary record to determine whether to preliminarily recommend that disciplinary charges be brought. If sufficient evidence is found, FINRA will provide the proposed respondent with a Wells notification. If insufficient evidence is found, FINRA may advise the subject of the investigation that it has decided not to bring disciplinary action at that particular time.

(ii) *The Wells Process*

Once FINRA has preliminarily determined to bring charges against a firm or individual, it will issue a Wells notice. Typically, an oral Wells notice is provided first, with a follow-up written notification. The firm or individual then has the opportunity to respond. Mr. Shorris emphasized that FINRA "carefully" considers Wells responses, and that the process is a "real" one, in that sometimes a Wells response convinces the staff not to bring charges.

(iii) *The New DAC Review Process*

Mr. Shorris described the new DAC process that applies to select cases. The DAC is a carryover from the NYSE, and it consists of members of FINRA Enforcement senior management. The DAC will review only a select minority of cases, including cases involving issues of high priority to FINRA or novel issues of fact or law. Based on its review, the DAC provides a recommendation to the FINRA staff attorney regarding the appropriate charges and sanctions.

(iv) *Statistics*

Ms. Merrill indicated that approximately 75%-80% of investigations conducted by the home offices result in formal action. She attributed this high percentage to the fact that home office investigations are opened after a preliminary review has already been conducted by FINRA's Strategic Initiatives Group. Similar statistics were not provided for regional investigations.

(d) The Settlement Process

Ms. Merrill stated that over 90% of cases brought by FINRA settle or result in a default judgment. The panelists discussed the following issues relating to the settlement process: (1) receiving credit for cooperation; (2) negotiating the settlement document, called a Letter of Acceptance, Waiver and Consent (AWC); (3) review by FINRA's Office of Disciplinary Action (ODA); and (4) publication of the settlement.

(i) *Receiving Credit for Cooperation*

Mr. Shorris indicated that extraordinary cooperation can result in lower disciplinary sanctions. He identified as the "gold standard" a firm that detects misconduct on its own and, prior to a FINRA investigation, takes prompt remedial action and self-reports it to FINRA. However, FINRA has been willing to give credit for cooperation that falls short of that standard. Mr. Shorris cited a recent example where a firm received a reduced fine for taking remedial actions after an NASD examination detected a problem with the firm's NAV transfer systems and procedures.

(ii) *Negotiating the AWC*

Mr. Shorris explained that the first step in the settlement process is negotiation regarding the potential charges and sanctions. Once FINRA and the respondent reach an agreement in principal regarding the charges and sanctions, FINRA staff will prepare a draft of the AWC. The next step involves negotiation between FINRA staff and the respondent regarding the precise language of the AWC, which usually takes the form of an exchange of AWC drafts. Once FINRA staff and the respondent agree to the language of the AWC, the AWC, along with related information, including any Wells response, is sent to ODA for its review and approval.

(iii) *ODA Review*

Mr. Shorris stated that ODA is independent from Enforcement, and its purpose is to vet settlements to ensure that the settlement is consistent with precedent, that the charges are appropriate and that the charges are supported by sufficient evidence. Mr. Shorris indicated that fairly infrequently, in fewer than 20% of cases, ODA refuses to accept the AWC, which means that the AWC must be renegotiated.

(iv) *Publication of the Settlement*

Once a settlement is finalized, a notice of the settlement will be published in FINRA's monthly summary of disciplinary actions. In addition, for significant settlements, FINRA will issue a press release. Press

releases are issued in only a small fraction of cases, and the language of the press release closely tracks the language of the AWC. Nonetheless, respondents are given a short period of time to review the press release for errors prior to its publication.

Currently, the AWC itself is not available on FINRA's Web site, but can be obtained upon request. Ms. Merrill noted that this practice is consistent with NASD's tradition, but that the NYSE, in contrast, did publish settlement documents on its Web site. Ms. Merrill indicated that FINRA is currently in the process of "harmonizing" that discrepancy.

(e) Litigation

If a settlement is not reached, Enforcement will draft a complaint setting forth the charges, in consultation with FINRA's Litigation Group. All complaints must be approved by ODA. Once approved, the complaint is filed with the Office of Hearing Officers (OHO), at which point it will be served on the respondent. Additional detail regarding the litigation process was discussed by the Disciplinary Process II: Adjudications panel and is summarized below.

(2) FINRA's Enforcement Priorities

Ms. Merrill highlighted a few of Enforcement's biggest priorities, including the following:

- ***Intersection of Unregistered Offerings, Anti-Money Laundering and Penny Stock Manipulation.*** Ms. Merrill stated that FINRA is finding that firms are failing to adequately monitor suspicious trading activity, despite the fact that broker-dealers have a gatekeeper duty under Section 5 of the Securities Act of 1933 and that broker-dealers have anti-money laundering obligations. FINRA will target firms where their poor systems have served as a conduit for "pump and dump" schemes and penny stock manipulation.
- ***Seniors and Retirees.*** FINRA is focusing on pitches to prospective retirees, 72(t) withdrawals, suitability of sales and reverse mortgages. With respect to reverse mortgages, FINRA is concerned that seniors and retirees are being urged to take out a mortgage and to use the proceeds to finance unsuitable investments.

For additional information about these issues, please see:

- Sutherland's Legal Alert titled, "FINRA Conducting a Sweep Examination of Pitches to Retirees and Section 72(t) Withdrawals," available [here](#).
- FINRA Regulatory Notice 07-43 on Senior Investors, available [here](#).
- FINRA Investor Alert titled, "Reverse Mortgages: Avoiding a Reversal of Fortune," available [here](#).
- ***Subprime Credit Crisis.*** FINRA is investigating various issues relating to the subprime credit crisis, including:
 - ***Suitability of Mortgage-Backed Securities Sales.*** Ms. Merrill indicated that FINRA is looking at the retailization of mortgage-backed securities and how they were sold to investors. FINRA is particularly concerned that such securities were sold to investors with conservative investment objectives. Ms. Merrill cited FINRA's finding that certain registered representatives were advised by their broker-dealers that mortgage-backed securities were "as good as government securities."
 - ***Conflicts of Interest.*** FINRA is investigating certain large firms that played multiple roles with respect to the subprime market to determine whether there were any conflicts of interest and

whether they were disclosed to customers. Ms. Merrill cited the example of a firm wearing several hats when selling the mortgage-backed securities to its customers. The firm was both an affiliate of an issuer of the mortgages and an underwriter of certain mortgage-backed securities.

- o *Sales of Auction Rate Securities.* FINRA is looking at representations made regarding the liquidity of these securities. Ms. Merrill noted that FINRA is focusing on sales of Auction Rate Securities made after the “market seized up.”

B. Disciplinary Process II: Adjudications

This panel discussed the adjudicatory process for FINRA disciplinary actions. This panel picked up where the Disciplinary Process I: Investigations panel left off – Enforcement’s filing of a complaint with OHO. The panel and the written material focused on the following steps in the adjudicatory process: (1) assignment of a Hearing Officer, (2) discovery, (3) the pre-hearing conference, (4) appointment of the Hearing Panel, (5) determinations regarding expert witnesses, (6) pre-hearing submissions, (7) the hearing, (8) Hearing Panel deliberations, (9) the Hearing Panel’s decision and (10) reviews of the Hearing Panel’s decision. The panel participants included Ms. Fienberg, David Fitzgerald, FINRA Senior Vice President and Deputy Chief Hearing Officer, and two industry members who had served on several Hearing Panels.

(1) Assignment of a Hearing Officer

Once a complaint is filed, the Deputy Chief Hearing Officer assigns the case to a Hearing Officer. The Hearing Officer conducts pre-hearing conferences, rules on procedural and evidentiary issues, acts as the Chair of the Hearing Panel and ultimately authors the Hearing Panel’s decision.

(2) Discovery

NASD rules require that Enforcement make documents it obtained during its investigation available to respondents for copying, including documents obtained from sources other than the respondents (e.g., documents obtained from customers). In addition, Enforcement must also provide respondents with transcripts from on-the-record interviews conducted by FINRA staff during the investigation.

(3) The Pre-Hearing Conference

At the pre-hearing conference, which is conducted by the Hearing Officer, the parties agree to a pre-hearing schedule and set the hearing dates and a hearing location.

(4) Appointment of the Hearing Panel

The Hearing Panel consists of the Hearing Officer and two other panelists. The other panelists are appointed as follows. After the hearing date and location have been set, the Hearing Officer sends an email to members of the relevant FINRA district asking for volunteers to serve on the Hearing Panel. The email sets forth the hearing date and location, as well as any areas of special expertise relevant to the case. The email does not identify the respondents. A second email is sent to those persons who expressed interest in serving on the Hearing Panel. This email identifies the respondents and asks the potential panelists to confirm that they have no conflicts of interest. The Hearing Panelists are selected based on responses to that second email. The session panelists discussed motions to disqualify or recuse a Hearing Panel member.

(5) Determinations Regarding Expert Witnesses

During the pre-hearing process, Enforcement and respondents are required to identify any proposed expert witnesses. The Hearing Panel has the discretion to allow or disallow proposed expert testimony. The session panelists stated that they believed that expert witnesses are rarely, if ever, critical to the outcome of a case because the Hearing Panel members know the industry. Exceptions might exist in certain technical cases.

(6) Pre-Hearing Submissions

Under the rules, Enforcement and respondents must file a pre-hearing submission. The pre-hearing submission must include, at a minimum, a list of proposed witnesses, a list of proposed exhibits and copies of all proposed exhibits. In addition, pre-hearing briefs are permitted, and in some cases, may be required by the Hearing Panel. Furthermore, if expert testimony is allowed, the party using the expert must provide a report from the expert setting forth in detail his or her planned testimony. The session panelists warned that these briefs should not promise evidence that “cannot be delivered” because it will affect credibility.

(7) The Hearing

The format of the hearing is similar to a court trial; however, the most notable difference is that formal rules of evidence do not apply. The hearing begins with each party providing an opening statement. Enforcement calls its witnesses and offers its exhibits. Respondents have the opportunity to cross-examine all witnesses and object to any exhibits. Next, respondents call their witnesses and offer their exhibits. Enforcement has the right to cross-examine all witnesses and object to any exhibits. The session panelists explained that evidence on both liability and sanctions should be presented. In addition, the session panelists stated that in-person witnesses are far more helpful to a Hearing Panel than telephone witnesses or affidavits because witness credibility is key. They also stated that they do not find character witnesses to be helpful. Once each party has presented its evidence, the Hearing usually concludes with each party making a closing statement. At that time, the parties may request the opportunity to submit a post-hearing brief, or the Hearing Panel may direct the parties to do so. The session panelists discussed whether it is in the respondents’ best interest to retain counsel at all or whether to retain counsel for each individual respondent.

(8) Hearing Panel Deliberations

After the hearing ends, the Hearing Panel meets to deliberate. Sometimes the meeting occurs immediately after the hearing concludes; other times the Hearing Panel waits to review the post-hearing submission and/or to review a copy of the hearing transcript and exhibits in more detail. The Hearing Panel’s decision is based on a majority vote; however, in practice, almost all Hearing Panel decisions are unanimous. The session panelists noted that Hearing Panels do not look at settlements (Letters of Acceptance, Waiver and Consent) to help assess the evidence or determine appropriate sanctions.

(9) The Hearing Panel’s Decision

The Hearing Officer drafts the written decision setting forth the Panel’s findings and conclusions. The Hearing Officer circulates the decision to the other panelists for their review and comment. The Hearing Officer incorporates the panelist’s revisions. If a panelist dissents from the decision of the Panel, he or she may file a written dissenting opinion. The Hearing Panel’s decision, along with any dissent, is served on the parties and published on FINRA’s Web site. The session panelists discussed the process by which they reached their decisions, emphasizing credibility of the respondent.

(10) Reviews of the Hearing Panel's Decision

Any party, including Enforcement, may appeal the Hearing Panel's decision to the National Adjudicatory Council (NAC). In addition, the NAC has the authority to call any Hearing Panel decision for review, even if neither party appeals. The NAC consists of seven industry members and seven non-industry members. Cases are initially referred to a two-member subcommittee of current or former members of the NAC or Board of Governors. The subcommittee reviews the record, hears oral argument (if requested) and submits a proposed decision to the full NAC for consideration. The NAC's review is de novo, meaning that no deference is given to the Hearing Panel's determinations, except as to credibility. The NAC may affirm the Hearing Panel's decision, dismiss the case, modify or reverse the findings or sanctions, or remand the case to the Hearing Panel for further proceedings.

A respondent may appeal a NAC decision to the SEC. The SEC reviews the case de novo, and can affirm, reverse or modify the NAC's findings, as well as the sanctions imposed. SEC decisions can be appealed by any respondent to the U.S. Court of Appeals.

C. Insurance Products Regulation

The Insurance Products Regulation panel discussed: (1) the recently proposed amendments to NASD Rule 2821; (2) investigations by the Florida Department of Financial Services regarding annuities; and (3) one firm's approach to helping its registered representatives understand variable annuity riders.

(1) Proposed Amendments to Rule 2821

Lawrence Kosciulek, Director of Investment Companies Regulation, outlined the proposed amendments to Rule 2821 that FINRA filed with the SEC on May 21, 2008. The proposed amendments include changes to the portions of Rule 2821 that are already effective (Rule 2821(a)-(b) and (e)) and those that have not yet become effective (Rule 2821(c) and (d)). Mr. Kosciulek highlighted the following key changes:

- **Rule Limited to Recommended Transactions.** The proposed amendments would limit the application of Rule 2821 to recommended transactions. This would eliminate the requirement under the approved, but not yet effective, Rule 2821(c) that the principals treat "all transactions as if they have been recommended for purposes of the principal review."
- **New Triggering Date for Seven Business Day Review.** Under the proposed amendments, principals would have seven business days from the date the firm's office of supervisory jurisdiction (OSJ) receives a complete and correct copy of a deferred variable annuity application to review and approve the application. Previously, the triggering date for the seven business day review was the date the customer signed the application.
- **Clarification regarding 36-Month Look Back.** Under Rule 2821, members and associated persons must consider whether the customer had another deferred variable annuity exchange within the preceding 36 months. The proposed amendments would clarify in supplementary material that members and associated persons must make "reasonable efforts" to ascertain whether the client had another deferred variable annuity exchange within the preceding 36 months. Further, an inquiry to the customer would constitute a "reasonable effort" in this context, provided that members document in writing both the inquiry and the customer's response.

Interested parties are invited to comment on the proposed amendments. Comments are due 21 days after the proposed amendments are published in the Federal Register. To view the full text of the proposed amendments, please click [here](#).

(2) Annuity Investigations by the Florida Department of Financial Services

Barry Lanier, Chief of the Bureau of Investigation of the Florida Department of Financial Services, stated that Florida's investigations of annuities have "increased significantly" in recent years. In fact, annuities rank second in terms of product type investigated, behind homeowner insurance policies. Of the annuity investigations opened in 2006-2007, approximately 43% involved equity indexed annuities, approximately 32% involved fixed annuities and approximately 25% involved variable annuities. Data from 2008, however, shows that the trend is shifting. As of April 30, 2008, over 40% of the investigations have involved variable annuities. Specific subjects of interest include unsuitable sales to seniors, sources of funding the annuity, twisting² and bonuses.

Mr. Lanier also noted that Florida recently passed legislation relating to licensed insurance agents. The legislation, among other things, significantly expands the information required to make a suitability determination, permits the use of only certain recognized professional designations, and prohibits insurance agents from falsely stating or implying that they are qualified to discuss securities or other investment products.

(3) Understanding Variable Annuity Riders

One industry panelist noted the challenge broker-dealers face in trying to ensure that their registered representatives understand variable annuities, particularly in light of the recent proliferation of living death benefit riders. One firm has confronted this challenge by publishing to its field force a detailed white paper on living benefits and a list of preferred riders. The white paper described how living benefits work; how living benefits differ from each other; who should buy them and who should not buy them; which living benefits are important and why; and the differences between a Guaranteed Minimum Income Benefit (GMIB), a Guaranteed Minimum Withdrawal Benefit (GMWB) and a Guaranteed Minimum Account Benefit (GMAB). The firm determined the preferred list of riders by performing a detailed analysis of each rider and scoring the relevant features of each rider. Riders that obtained a certain minimum score were included on the preferred list. The firm has received positive feedback on the preferred list from its representatives and the insurance companies that issue the variable annuities.

D. Advertising Regulation

This panel addressed, among other things, the following recently proposed or soon-to-be proposed rule revisions:

- **Variable Insurance Product Guidelines.** Advertising Regulation has submitted to FINRA's Board of Governors revised guidelines for communications with the public about variable insurance products. The current guidelines are embodied in IM-2210-2 and were originally created in 1993. Among other things, the revised guidelines focus on illustrations.
- **Principal Approval Exception for Filed Sales Material.** The SEC recently approved an amendment to Rule 2210 that creates an exception to the principal approval requirement for certain previously filed sales materials. To qualify for the exception, (1) the sales material must have received a "consistent with applicable standards" letter from Advertising Regulation; and (2) there must be no material changes to the content of the sales material; and (3) the sales material may not

² A Florida statute defines twisting to include, among other things, knowing misrepresentations or material omissions made for the purpose of inducing a person to lapse, surrender, terminate, borrow on, retain, or convert any insurance policy or to purchase a policy of insurance from another insurer.

be used in a manner inconsistent with any conditions in Advertising Regulation's approval letter. The panel stated that FINRA planned on creating a repository of previously approved material. They stressed that the principal approval exception did not obviate the filing requirement—firms must retain copies of the sales material and relevant Advertising Regulation approval letter.

For additional information concerning the principal approval exception, please see FINRA Regulatory Notice 08-12, available [here](#).

- **Market Letters as Correspondence.** FINRA is proposing to remove “market letters” from the definition of “sales literature” under Rule 2210, and to include “market letters” in the definition of “correspondence” under Rule 2211. “Market letters” would therefore no longer need to be approved by a principal prior to use, unless the letter was distributed to 25 or more existing retail customers within any 30 calendar-day period and made a financial or investment recommendation or otherwise promoted a product or service offered by the member.
- **Proposed Amendments to Rule 2220.** FINRA recently proposed amendments to Rule 2220 regarding communications with the public regarding options. Some of the most notable proposed changes include:
 - The definitions of “advertisement,” “sales literature,” “independently prepared reprint,” “correspondence,” “institutional sales material” and “public appearance” from Rules 2210 and 2211 would be incorporated into Rule 2220;
 - Principals would be required to review correspondence concerning options in the same manner as they are required to review correspondence generally under Rule 2211;
 - Principals would be required to review institutional sales material regarding options in the same manner as they are required to review institutional sales material generally under Rule 2211;
 - Members would be required to retain copies of options communications in accordance with SEC Rule 17a-4 and also to retain the names of the person(s) who prepared the communications and the source of any recommendations contained therein in the form and for the time period required under Rule 17a-4;
 - A new term “standardized option” will be added to the rule and defined as “any option contract issued, or subject to issuance, by The Options Clearing Corporation, that has standardized terms for the strike price, expiration date and amount of the underlying security, and is traded on a national securities exchange registered pursuant to Section 6(a) of the [Securities Exchange] Act”;
 - All communications concerning “standardized options” used prior to delivery of the applicable current options disclosure document or prospectus would be required to be filed with FINRA Advertising Regulation at least 10 calendar days before first use;
 - All communications regarding “standardized options” exempted under SEC Rule 238 of the Securities Act of 1933, which are used prior to the delivery of the options disclosure document, would be limited to “general descriptions” of the options being discussed;
 - All communications regarding options not exempted under SEC Rule 238, which are used prior to delivery of a prospectus, would have to meet the requirements of Section 10(a) of the Securities Act and Rules 134 and 134s thereunder;

- All options communications, except institutional sales material, would be required to include a statement that documentation supporting any claims, comparison, recommendations, statistics or other data contained in the communication will be available upon request;
- Projected and historical performance figures would be permitted in any options communication, provided that all relevant costs are disclosed and reflected therein and, if the communication concerns a “standardized option,” it is used after, or concurrent with, the delivery of the options disclosure document; and
- Any violation of any rule or requirement of the SEC or the Securities Investor Protection Corporation applicable to member communications regarding options would also be deemed a violation of Rule 2220.

The comment period for the proposed amendments closed as of May 23, 2008. To view the full text of the proposed amendments to NASD Rule 2220, please click [here](#).

The panel also focused on certain core content requirements, including that pieces should not contain superlatives or list “best” or “worst,” unless there is clear evidence to support such claims. In addition, the panel used several hypothetical marketing materials to explain the application of the relevant rules.

E. Supervisory Controls

This panel session discussed several issues relating to member firm’s supervisory obligations, including:

- **Proposed FINRA Supervision Rules.** The Panel discussed Notice to Members 08-24 and the proposed changes to the supervision rules. FINRA is proposing to delete current Rule 3012’s requirement relating to the supervision of a producing manager’s customer account activity, including the requirement to impose heightened supervision when a producing manager’s revenues exceed a certain threshold. In addition, FINRA has proposed Rule 3110(b)(6), which will require firms to have procedures prohibiting supervisors from supervising their own activities, or from reporting to, or having their compensation or continued employment determined by, someone they are supervising. Firms must also prevent such supervision from being lessened due to any conflicts of interest that may be present, including conflicts resulting from compensation the supervisor derives from the supervisee.

Other significant requirements of the proposed rules include:

- Firms would be required to designate an appropriately registered principal with authority to supervise each type of business in which the member engages, whether or not such activity would require broker-dealer registration;
- Firms would be required to have supervisory procedures that require a registered principal to review all transactions relating to the firm’s investment banking or securities business; and
- Firms would be required to supervise all approved outside “investment banking or securities business,” regardless of whether or not the registered representative receives “selling compensation.” (This provision would replace current Rule 3040.)

To view all of FINRA’s proposed supervision rules, please click [here](#).

- **Testing and Verification Required by NASD Rule 3012.** The panel discussed that Rule 3012 requires, among other things, that member firms establish, maintain and enforce a system of supervisory control policies and procedures that test and verify that the firm’s supervisory policies and

procedures are reasonably designed to achieve compliance with applicable rules and regulations. This requirement is distinct from firms' obligations to establish, maintain and enforce a supervisory system and written procedures under Rule 3010. The panelists also suggested certain tips for complying with Rule 3012, including:

- Comparing the firm's procedures with the templates contained on FINRA's Web site;
 - Reviewing and maintaining all regulatory notices, extracting those that are relevant
 - Maintaining a separate file for materials relating to each of the NASD rules relating to supervision (NASD Rules 3010, 3012 and 3013);
 - Ensuring that persons performing the testing communicate with the business units to understand what they are doing and why;
 - Ensuring that the testing involves a risk-based analysis that takes into account, for example, issues identified by customer complaints, internal and external audits, industry sweep examinations and sources of revenue;
 - Creating and using a grid or checklist to identify and analyze supervisory controls;
 - Using an outside firm or vendor to perform testing is permitted, but the broker-dealer is ultimately responsible; and
 - Relying on internal audit to perform testing is permissible, but the firm must ensure that the auditing is sufficient to comply with the rule.
- **The Limited Resources Exception to Rule 3012.** The panelists underscored that this exception only applies to a small part of Rule 3012 – the requirement that producing managers be supervised by an independent person. The panelists stressed that if a firm claims this exception, it should clearly document its basis for doing so.
- **Examination Findings Relating to Supervisory Controls.** The panelists stressed that examiners review the report to make sure that processes are in place. They rarely review it to guide the staff with regard to possible violations. However, if the firm has systematic or egregious violations, the staff will look at the report to see if the firm was testing and taking steps to address problems. If the firm was performing such testing, and addressed problematic issues, that could provide mitigation. The following are among examples of deficiencies noted in recent examinations relating to Rule 3012:
- Failing to distinguish between the supervisory control system and written supervisory procedures;
 - Failing to have procedures to address testing;
 - Failing to designate a principal to oversee the supervisory system;
 - Failing to do annual testing and verification;
 - Failing to adequately supervise producing branch managers; and
 - Failing to prepare and timely submit the report

The staff noted that fewer than 10 firms had substantial 3012 violations.

F. Broker-Dealer and Investment Adviser Issues

This panel focused on three issues: (1) different business models; (2) the RAND study; and (3) the North American Securities Administrators Association (NASAA) Coordinated Investment Adviser Examination.

(1) Different Business Models

A consultant discussed different business models addressing the relationship between both representatives and their firms and between representatives and their clients. Across a spectrum, a firm or a representative may “own” the relationship with the client. Similarly, a spectrum exists regarding the representative’s relationship with the client, ranging from simply executing transactions to acting as a fiduciary and providing advice.

(2) RAND Study

An SEC official discussed the recently released RAND study on investment advisers and broker-dealers. That study, requested by the SEC and conducted by RAND Corporation, analyzed how investment advisers and broker-dealers interact with their clients. Among the more notable findings of the RAND study were:

- The financial services industry is very “heterogeneous,” with firms that use diverse business models and offer various products and services;
- Retail investors typically do not understand the difference between brokers and advisers; and
- Most retail investors are happy with their financial service providers.

The SEC official noted that SEC staff will be presenting options to the Chairman’s office, not recommendations on how to address the issues raised by the RAND study. To view the RAND study, please click [here](#).

(3) NASAA Coordinated Investment Adviser Examination

The panel and the session materials discussed the results of the NASAA Coordinated Investment Adviser Examination. As part of the exam, 418 investment advisers were reviewed by securities examiners from the U.S. and Canada. Of the 418 advisers, 104 were also affiliated with a broker-dealer. The exam found 2,135 deficiencies. The most common categories of deficiencies included:

- **Registration Deficiencies.** Over 71% of the advisers had at least one registration deficiency. Registration deficiencies included, among other things, violations relating to Form ADVs (e.g., content violations, failure to update, failure to update timely and delivery failures).
- **Unethical Business Practices Deficiencies.** Over 47% of the advisers had at least one deficiency relating to unethical business practices. Unethical business practices deficiencies included, among other things, advisory contract deficiencies (e.g., unsigned or undated contracts, missing contracts), unsuitable recommendations, unauthorized trades, excessive fees and conflicts of interest.
- **Books and Records Deficiencies.** Over 45% of the advisers had at least one books and records deficiency. Examples of books and records deficiencies included failure to document suitability information, deficiencies relating to financial statements and e-mail deficiencies.

- **Supervisory Deficiencies.** Over 36% of the advisers had at least one supervisory deficiency. Supervisory deficiencies included lack of procedures, inadequate procedures and failure to enforce procedures. Lack of procedures accounted for nearly half of all the supervisory deficiencies.
- **Privacy Deficiencies.** Over 27% of the advisers had deficiencies relating to privacy regulations. Most of these deficiencies were based on the advisers' failure to have a privacy policy and failure to deliver the policy on an annual basis.

The exam also found that broker-dealer affiliated investment advisers had slightly more registration deficiencies and unethical business practices deficiencies than non-broker-dealer affiliated advisers. However, broker-dealer affiliated investment advisers had significantly fewer books and records deficiencies and slightly fewer supervisory deficiencies and privacy deficiencies than their non-broker-dealer affiliated counterparts.

Based on the exam findings, the panelists recommended several "best practices" for investment advisers, including the following:

- Review and revise Form ADVs and disclosure brochures on an annual basis to ensure that they reflect current and accurate information;
- Review and update all contracts;
- Prepare and maintain client profiles;
- Calculate and document fees correctly and consistent with contracts and Form ADVs;
- Review all advertisements, including Web sites and performance advertising, for accuracy;
- Prepare and distribute a privacy policy initially and annually; and
- Prepare, maintain and enforce written supervisory procedures.

G. Credit Market Issues

This panel session explored issues relating to the credit market crisis. Ms. Vogel, who heads FINRA's Department of Risk Oversight and Operation Regulation, introduced the session by citing several significant statistics, including that the credit crisis has resulted in more than \$310 billion in writedowns and credit losses and the loss of more than 48,000 jobs. The panel discussed FINRA's efforts in this area, including its examination of subprime valuation and its concerns relating to auction rate securities. The panel also addressed some of the lessons learned from the crisis.

(1) FINRA's Examination of Subprime Valuation

Anand Ramtahal, the Senior Vice President and Regional Director in the Risk Oversight and Operational Regulation Department of FINRA Member Regulation, presented the findings of FINRA's examination of subprime valuation. This examination principally concerned inventory valuation and pricing practices. FINRA's exam found several deficiencies, including:

- Firms' Product Control Groups relied too heavily on traders' marks;
- Traders did not adequately document their valuation process;

- Firms were unable to provide evidence of the consistent application of valuation processes (e.g., firms inconsistently valued their inventory versus the assets they held as collateral);
- Firms' Product Control Groups were insufficiently staffed; and
- Firms had inadequate procedures regarding the issuance and resolution of margin calls or failed to adequately document the issuance and resolution of margin calls.

(2) FINRA's Concerns Regarding Auction Rate Securities

Ms. Vogel indicated that FINRA's concerns regarding auction rate securities are focused on point-of-sale disclosures, valuation and the presentation of auction rate securities on customer account statements. With respect to the last point, Mr. Ramtahal added that FINRA will "absolutely" question a firm if it is still presenting auction rate securities as cash equivalents. In addition, Mr. Ramtahal remarked that FINRA is also concerned with potential conflicts of interest when the firm either has a relationship with the issuer of the auction rate security or holds a proprietary position in the auction rate security.

(3) The Lessons of the Credit Market Crisis

The panelists discussed several lessons of the credit market crisis. For example, Mr. Ramtahal noted that the credit crisis underscored:

- The importance of a diverse portfolio;
- The need for contingency funding plans;
- The reliance solely on independent credit ratings is not a good practice; and
- The importance of firms examining risk on a firm-wide basis.

H. Fixed Income Compliance

The conference materials for this panel addressed, among other things: (1) FINRA Member Regulation's regulatory sweep of TRACE compliance and municipal bond transactions; and (2) the Municipal Securities Rulemaking Board's (MSRB's) 2008 agenda.

(1) Member Regulation's Sweeps

The materials focused on Member Regulation's automated review of market activity, and, in particular, sweeps of TRACE compliance and municipal bond transactions. In addition, they discussed the factors FINRA considers in determining whether the examination results warrant formal action.

(a) TRACE Sweeps

TRACE sweeps look at the following issues:

- Late reporting;
- Excessive commissions;
- Dealer mismatch / under or misreporting;
- Negative yields;

- Blank yield / no yield reported;
- Contra execution times;
- Compliance with Rule 6260 regarding underwriter late notice;
- Reporting of large blocks late; and
- Principal and commission.

The most common deficiencies identified by TRACE sweeps relate to:

- Reporting of yield;
- Reporting of incorrect execution times;
- Reporting of trades with a “C” instead of contra party; and
- System outages that result in late transactions.

(b) Municipal Bond Sweeps

Sweeps of municipal bond transactions examine the following issues:

- Late reporting;
- Negative yield;
- Excessive commissions;
- Time of trade;
- Time of execution;
- Contra Market Principal Identifier (MPID); and
- Reporting of large blocks late.

Sweeps of municipal bond transactions frequently identify the following deficiencies:

- Failure to use special condition indicators;
- Over-reporting; and
- System outages that result in late transactions.

(c) Formal Actions

In determining whether formal action is warranted, FINRA will consider, among other things, the egregiousness of the violations, whether the firm took any corrective action, the firm’s performance in subsequent review periods and the firm’s disciplinary history.

(2) MSRB's 2008 Agenda

MSRB's agenda for 2008 includes the following issues:

- **Electronic Municipal Market Access (EMMA).** EMMA is an internet-based repository for disclosure documents relating to municipal securities and municipal securities trade price data. Currently in its pilot phase, it is expected to be fully implemented by December 1, 2008, or shortly thereafter. EMMA will provide free public access to disclosure documents and real-time municipal securities trade data.
- **Review of Fair Pricing Rules.** MSRB Rule G-30 generally requires that prices for municipal securities be fair and reasonable, taking into account all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the security at the time of the transaction. However, NASD IM-2440-2 focuses on contemporaneous costs as the best indicator of prevailing market price. While NASD IM-2440-2 does not apply to municipal securities, the MSRB is nonetheless considering whether Rule G-30 should be revised to be more consistent with NASD IM-2440-2.
- **Trade Reporting Enhancements for Auction Rate Securities and Variable Rate Demand Obligations (VROs).** In March 2008, MSRB published a request for comment (MSRB Notice 2008-15) on a plan to create a centralized system for the collection and dissemination of critical market information about municipal auction rate securities. The plan would require dealers that operate auction rate programs to report auction information to a central system operated by the MSRB. In addition, the MSRB is exploring ways to increase transparency for VROs and expects to publish a notice seeking public comment on that issue soon.

To view MSRB Notice 2008-15, please click [here](#).

- **Review of Syndicate Practice Rules.** MSRB is reviewing its syndicate practice rules relating to the following issues: name give-up, proprietary desk trades, issue price certificates and Not Reoffered (NRO) maturities.
- **New Issue Information Dissemination System (NIIDs) Testing.** NIIDs is the result of the joint efforts of MSRB, the Deposit Trust & Clearing Corporation (DTCC) and the Securities Industry and Financial Markets Association (SIFMA). It will provide centralized collection and real-time dissemination of new issue information. MSRB rules will require underwriters to participate in NIIDs.

I. Anti-Money Laundering: Use of SARs

This panel, which included representatives from the Federal Bureau of Investigation, Internal Revenue Service, and Immigrations and Customs Enforcement, addressed the value of suspicious activity reports (SARs) to law enforcement. For example, Mark Hudson, Assistant Section Chief of the FBI Terrorist Finance Operations Section, stated that SARs and Currency Transaction Reports (CTRs) are "vital" to his efforts. In addition, the panelists provided anecdotes of how SARs triggered investigations and/or were useful in their prosecutions.

The panel also discussed how to draft an effective SAR. Michael Yasofsky, a Special Agent with the Internal Revenue Services, stated that in drafting SARs, firms should concentrate on addressing the five Ws—Who, What, When, Where and Why. In addition, Mr. Yasofsky urged firms to be "inclusive" of all suspicious activity and to include, where possible, the name of the employee(s) involved, the social security number of the suspicious person, and the middle name or initial of the suspicious person, if he or she has a common name.

J. Small Firm Compliance

This panel was devoted to providing small firms, which comprise approximately 80% of FINRA’s membership, practical tips for their compliance programs. In addition, the panel discussed the importance of FINRA’s Small Firm Advisory Board.

(1) Practical Tips

Mitchell Atkins, Vice President and District Director of FINRA’s Florida District Office, cited a bevy of resources offered by FINRA to aid small firms’ compliance programs, including:

- FINRA’s Small Firm Web Page, available at www.finra.org/smallfirms, which highlights issues of importance to small firms (e.g., the Small Firm Emergency Partner Program) and provides links to other pages of interest to small firms; and
- FINRA’s Compliance Tools Web Page, available at www.finra.org/compliancetools, which contains checklists, templates and other tools that may be useful to small firms.

(2) Small Firm Advisory Board

The Small Firm Advisory Board endeavors to ensure that issues of particular concern to small firms, including the potential impact of regulatory initiatives on small firms, are communicated to, and considered by, FINRA’s Board of Governors. Among other things, the Small Firm Advisory Board reviews all draft rules before they are submitted to FINRA’s Board of Governors. Louis Denton, Chairman of the Small Firm Advisory Board, stated that the Board is sometimes responsible for FINRA abandoning draft rules or substantially revising them, although these successes go “unreported.”



If you have any questions about the FINRA Spring Securities Conference, or the services we provide, please feel free to contact Brian L. Rubin (brian.rubin@sutherland.com), Shanyn L. Gillespie (shanyn.gillespie@sutherland.com) or any of the partners on our Securities Enforcement or Financial Services teams.

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