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Fundamentals of Broker-Dealer Regulation 2016

Practicing Law Institute Seminar

Panel: Broker-Dealer Exam Priorities and Hot Topics

Supplementary Material from Lee A. Schneider

July 26, 2016

Executive Summary

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The Securities Markets of the Future: Regulatory Priorities, Trading and Risk Management Practices

Panel: Regulatory Focus on Risk Management

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Moderated by Lee A. Schneider

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Agenda

- Financial Responsibility Requirements
  - Net Capital Rule (15c3-1)
  - Customer Protection Rule (15c3-3)
  - Required Books, Records, and Reports (17a-3, 17a-4, 17a-5, 17a-11)
  - Risk Assessment Requirements (17h-1T and 17h-2T)
- Risk Management Requirements for Broker-Dealers with Market Access (15c3-5)
- Liquidity Risk Management (FINRA Regulatory Notice 15-33)
- Risk Management Requirements under the EPS Rules
- Basel III - Fundamental Review of the Trading Book Rules

Financial Responsibility Requirements

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Financial Responsibility Requirements

Net Capital Rule – Rule 15c3-1

- Purpose. Requires a broker-dealer to have at all times enough liquid assets to promptly satisfy the claims of customers if the broker-dealer goes out of business.
- Rule.
  - Broker-dealers must maintain **minimum net capital levels** based upon the type of securities activities they conduct and based on certain financial ratios.
  - For example, broker-dealers that clear and carry customer accounts generally must maintain net capital equal to the greater of $250,000 or two percent of aggregate debit items. Broker-dealers that do not clear and carry customer accounts can operate with lower levels of net capital.

2016 FINRA Exam Priority: Market-Maker Net Capital Exemptions

- Rule 15c3-1 (b)(1) exempts options market-makers from the net capital rule if the firm, among other things, is engaged primarily in options market-making and does not engage in more than an occasional investment transaction unrelated to its options market-making business.
- FINRA will focus on **whether firms have properly claimed an exemption** under and operated consistent with subsection (b)(1) of the net capital rule.
- FINRA will also assess **whether firms are engaged in bona fide market-making and permissible hedging transitions** pursuant to the requirements of subsection (a)(6) of the net capital rule.

Financial Responsibility Requirements

Customer Protection Rule – Rule 15c3-3

- Purpose. Protects customer funds and securities held by broker-dealers by, in effect, forbidding broker-dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers.
- Rule.
  - A broker-dealer must have **possession or control** of all fully-paid or excess margin securities held for the account of customers, and determine daily that it is in compliance with this requirement.
  - The broker-dealer must also make **periodic computations** to determine how much money it is holding that is either customer money or obtained from the use of customer securities.
    - If this amount exceeds the amount that it is owed by customers or by other broker-dealers relating to customer transactions, the broker-dealer must deposit the excess into a special reserve bank account for the exclusive benefit of customers.
  - This rule thus prevents a broker-dealer from using customer funds to finance its business.

Financial Responsibility Requirements

Required Books, Records and Reports - Rules 17a-3, 17a-4, 17a-5, 17a-11

- Rules.
  - Broker-dealers must make and keep current books and records detailing, among other things, securities transactions, money balances, and securities positions.
  - They also must keep records for required periods and furnish copies of those records to the SEC on request. These records include e-mail.
  - Broker-dealers also must file with the SEC periodic reports, including quarterly and annual financial statements. The annual statements generally must be certified by an independent public accountant.
  - In addition, broker-dealers must notify the SEC and the appropriate SRO regarding net capital, recordkeeping, and other operational problems, and in some cases file reports regarding those problems, within certain time periods. This gives the SEC the SROs early warning of these problems.

Financial Responsibility Requirements

Risk Assessment Requirements - Rules 17h-1T and 17h-2T

- Purpose. Requires disclosure of certain information in order to permit the SEC to assess the impact certain entities may have on a broker-dealer.
- Rule.
  - Certain broker-dealers must **maintain and preserve certain information regarding those affiliates, subsidiaries and holding companies** whose business activities are **reasonably likely to have a material impact** on their own financial and operating condition (including the broker-dealer's net capital, liquidity, or ability to conduct or finance operations).
  - Broker-dealers must also file a quarterly summary of this information.

Key Amendments in 2013

SEC adopted amendments to financial responsibility rules that are now fully in effect

- Rule 15c3-1 amendments:
  - Consistent with prior staff guidance, net worth must be adjusted by including liabilities assumed by a third party that the third party lacks the resources to pay.
  - A capital contribution constitutes a liability if the investor has right or intention to withdraw within one year. Any capital contribution withdrawn within one year (unless pursuant to written permission of DEA) will be treated as having been made with the intention to withdraw.
  - Broker-dealer must deduct from net capital the amount of any deductible under its fidelity bond that is in excess of the deductible permitted by SRO rules.
  - Broker-dealer must cease business upon the occurrence of certain insolvency events, including bankruptcy, appointment of a receiver, a general assignment for the benefit of creditors, admission of insolvency, or the inability to establish compliance with Rules 15c3-1 and 15c3-3.
  - SEC has power to prevent broker-dealer from withdrawing capital, or making loans or advances to owners, officers, directors and affiliates when SEC deems necessary or appropriate to protect the financial integrity of the broker-dealer

Key Amendments in 2013

continued

SEC adopted amendments to financial responsibility rules that are now fully in effect

- Rule 15c3-3 amendments:
  - Harmonize definition of “customer” between this rule and the Securities Investor Protection Act by requiring carry brokers to maintain new type of reserve account for U.S. broker-dealer customers, that functions like Customer Reserve Account.
  - Reserve deposit (customer plus PAB) with any one bank cannot exceed 15% of bank’s equity capital, determined by reference to the most recent Call Report.
  - Deposits at affiliated banks do not qualify for reserve account treatment.
  - New customer disclosure and consent requirements for free credit balances and sweep accounts, including 30 day notice of changes to existing sweep program.
- Securities lending and repo amendments:
  - New requirements to more clearly distinguish when broker-dealer acts as agent for such transactions to avoid taking capital charges.
  - Notification to SEC whenever the total amount of money payable against all securities loaned or subject to repurchase agreements, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2500 percent of tentative net capital.

Key Amendments in 2013

continued

SEC adopted amendments to financial responsibility rules that are now fully in effect

- Risk Management Procedures
  - Amendments require documentation of procedures concerning various types of risk management controls, including those related to market risk, credit risk and liquidity risk, if the broker-dealer has such (for example, under the Market Access Rule). The rule exempts broker-dealers with (a) $1 million or less in aggregate credit items under Rule 15c3-3a or (b) $20 million or less in capital (including qualifying subordinated debt).
- Custody
  - The amendments created a new regulatory regime with respect to custody, including a report to SEC about compliance or exemption from custody requirements, portions of which are audited by broker-dealer's accounting firm.
  - New "Form Custody" asks for information about (a) whether the broker-dealer is an introducing or carrying broker, (b) value of assets in custody and their location, (c) who sends statements and confirms to customers, (d) whether customer have electronic access to account information and (e) whether the broker-dealer is, or is affiliated with, a registered investment adviser.

Market Access Rule
Risk Management Requirements

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Risk Management Requirements

Rule 15c3-5 - Overview

- Rule 15c3-5 requires **broker-dealers with or providing market access** to maintain a system of **risk management controls and supervisory procedures** reasonably designed to manage the financial, regulatory, and other risks.
- The controls and procedures must be reasonably designed to:
  - **Systematically limit the financial exposure** of the broker-dealer that could arise as a result of market access, including prevention of orders that exceed credit limits, price or size parameters, or might be duplicative orders.
  - **Ensure compliance with all regulatory requirements** applicable in connection with market access through checks prior to routing to the markets.
- Rule 15c3-5 further requires that these controls and supervisory procedures be (1) under the **direct and exclusive control** of the broker-dealer subject to the obligations (subject to certain limited exceptions), and (2) **reviewed regularly for effectiveness**.

Risk Management Requirements

Rule 15c3-5 – April 2011 FAQs

- Manual Execution. For purely manual orders and executions, the requirements of Rule 15c3-5 can be satisfied by **implementing manual pre-trade controls** rather than systems controls.
- Direct and Exclusive Control. **Risk management tools or technology provided by third parties** may be used if not customer-provided, so long as the broker-dealer has direct and exclusive control over those tools or technology. Among other things, the broker-dealer providing market access must have the ability to **directly monitor**, and the **exclusive ability to adjust**, the operation of the financial and regulatory risk management controls **in real time**.
- Setting Credit and Capital Thresholds.
  - The selection of a particular dollar amount as an appropriate credit or capital threshold necessarily will require the exercise of **reasonable business judgment** on the part of the broker-dealer with market access.
  - Such determinations should be based on appropriate due diligence as to the customer's business, financial condition, trading patterns, and other matters.
  - While broker-dealers will have flexibility in exercising reasonable business judgment as to an appropriate credit or capital threshold for a particular customer or its own business for purposes of Rule 15c3-5, the broker-dealer should be **prepared to show why** it selected a particular threshold, how that threshold meaningfully limits the financial exposure potentially generated by the customer or its own trading activity, and the process by which it monitors the continued appropriateness of those thresholds on an ongoing basis.

Broker-Dealer Liquidity Risk Management

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FINRA Regulatory Notice 15-33

- FINRA Regulatory Notice 15-33 titled “Guidance on Liquidity Risk Management Practices” stakes out FINRA’s position on liquidity risk management as an important function for its member broker-dealers.
- With the Notice, FINRA now seeks to have its member broker-dealers make liquidity management part of their best practices: “[e]ffective liquidity management is a **critical control function** at broker-dealers and across firms in the financial sector.”

2016 FINRA Exam Priority: Firm Funding

- FINRA will review the **adequacy of firms’ contingency funding plans** in light of their business models.
- The framework for these reviews will consider many of the effective practices contained in Regulatory Notice 15-33 (*e.g.*, that firms rigorously evaluate their liquidity needs related to both market-wide and idiosyncratic stresses, develop contingency plans so that they have sufficient liquidity to weather those stresses, and conduct stress tests and other reviews to evaluate the effectiveness of their contingency plans).
- In addition, FINRA will focus on the **adequacy of high-frequency trading (HFT) firms’ liquidity planning and controls**. Given the number of orders HFT firms have in the market at one time, sudden changes in a firm's execution rate—whether triggered by a market event or other factors—could create liquidity challenges for a firm.

Liquidity Risk Management Practices

FINRA Regulatory Notice 15-33

- Management Oversight. FINRA expects management to develop a system to review and understand sources of funding and the liquidity process, as well as the scenarios in which those sources may become limited or completely unavailable.
- Risk Measurement. Firms should ensure that their systems appropriately calculate cash outflows under particular stress scenarios and that these calculations are reported to senior managers who will then determine how to address liquidity stress when it arises.
- Stress Testing. Each firm should conduct regular stress testing appropriate to its size and business activities that incorporates issues seen in recent and historical market events.
- Sources of Funding. As counterparties may limit or discontinue funding or apply greater collateral haircuts during stress events, firms should assess how their lenders and other sources of funding may react, including by considering reasonable haircut ranges for assets.

Liquidity Risk Management Practices

FINRA Regulatory Notice 15-33

- Contingent Funding.
  - FINRA's guidance also indicates that firms should have a well-developed contingent funding plan.
  - This plan should include a committed facility dedicated specifically to the firm, rather than one committed to multiple affiliates, as this could limit its availability during a stress event.
- Liquidation.
  - A firm's liquidity risk management program should include a cushion for losses in inventory positions.
  - In the Notice, FINRA states that firms should give consideration to selling less liquid securities, as well as more marketable positions such as government securities or highly rated corporate debt, when needing to increase liquidity.
- Customer Withdrawal of Funds. Daily computations of customer reserve account requirements appear to be expected under the Notice, as many of the observed firms indicated that they could conduct daily computations in a stressed environment

EPS Rules

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EPS Rules

Risk Management Requirements

- Management. Under the Federal Reserve's "Enhanced Prudential Standards" (Regulation YY), BHCs and certain FBOs with total consolidated assets of $50B or more must:
  - Maintain a **risk committee** that approves and periodically reviews the risk-management policies of the BHC's global operations and oversees the operation of the BHC's global risk-management framework; and
  - Appoint a **chief risk officer**.
- Risk Management Framework. The risk management framework must be commensurate with its structure, risk profile, complexity, activities, and size and must include:
  - **Policies and procedures** establishing risk-management governance, risk-management procedures, and risk-control infrastructure for its global operations; and
  - **Processes and systems** for implementing and monitoring compliance with such policies and procedures, including:
    - » Processes and systems for identifying and reporting risks and risk-management deficiencies, including regarding emerging risks, and ensuring effective and timely implementation of actions to address emerging risks and risk-management deficiencies for its global operations;
    - » Processes and systems for establishing managerial and employee responsibility for risk management;
    - » Processes and systems for ensuring the independence of the risk-management function; and
    - » Processes and systems to integrate risk management and associated controls with management goals and its compensation structure for its global operations.

EPS Rules

Liquidity Risk Management Requirements

- Cash Flow Projections.
  - **BHCs and certain FBOs with total consolidated assets of $50B or more** must produce comprehensive cash-flow projections that project cash flows arising from assets, liabilities, and off-balance sheet exposures over, at a minimum, short- and long-term time horizons.
  - The BHC or FBO must update short-term cash-flow projections daily and must update longer-term cash-flow projections at least monthly.
- Contingency Funding Plan. Must establish and maintain a contingency funding plan that sets out the company's strategies for addressing liquidity needs during liquidity stress events.

EPS Rules

Liquidity Risk Management Requirements Cont.

- Risk Limits. Must monitor sources of liquidity risk and establish limits on liquidity risk, including limits on:
  - Concentrations in sources of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and as applicable, other forms of liquidity risk;
  - The amount of liabilities that mature within various time horizons; and
  - Off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.
- Risk Monitoring.
  - *Collateral*. Must establish and maintain policies and procedures to monitor assets that have been, or are available to be, pledged as collateral in connection with transactions to which it or its affiliates are counterparties.
  - *Legal Entities, Currencies and Business Lines*. Must establish and maintain procedures for monitoring and controlling liquidity risk exposures and funding needs within and across significant legal entities, currencies, and business lines, taking into account legal and regulatory restrictions on the transfer of liquidity between legal entities.
  - *Intraday Exposures*. Must establish and maintain procedures for monitoring intraday liquidity risk exposure.

Fundamental Review of the Trading Book Rules

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Overview

Basel Committee Developments

- Fundamental Review. Basel Committee began a fundamental review of the market risk capital requirements in 2012. There have been three consultations.
  - First Consultative Document – May 2012
  - Second Consultative Document – October 2013
  - Third Consultative Document – December 2014
- QIS. Consultations accompanied by QIS to study impact of proposed revisions
- Prior Revisions. Basel 2.5 Revisions attempted to address cyclicality of the existing market risk framework and increase overall level of capital.
- Final Rule. The Basel Committee finalized the FRTB in January 2016.

FRTB is relevant for broker-dealers because it puts an additional burden on brokers.

Highlights

Basel Committee Developments

- Trading Book/Banking Book Boundary.
  - Additional prescribed inclusions and exclusions.
  - Explicit guidance on the treatment of internal risk transfers.
  - Heightened restrictions on transfers in and out of trading book.
- Model Approval.
  - Increased and more granular formal requirements for model approval.
  - Approval provided at **desk level**.
- VaR and SVaR.
  - VaR and SVaR (99% confidence level) replaced by three types of expected shortfall (97.5% confidence level); one day VaR maintained for backtesting.
  - Use of full or partial revaluation and multiple liquidity horizons.
  - Risk class categorization and reduced diversification benefits.
  - More computationally intensive.

Highlights

Basel Committee Developments

- VaR Backtesting.
  - VaR backtesting at both 99% and 97.5% confidence level.
  - Introduction of risk theoretical P&L to hypothetical P&L comparison.
  - Fallback to Standardized Approach if failure to meet backtesting and PL attribution standards.
- Risks not in VaR/Market Data Proxy.
  - Formal criteria to determine modelable risk factors (continuously available "real price").
  - Formal capitalization of non-modelable risk factors through an add-on using an undiversified approach.
- Incremental Risk Charge (IRC).
  - Removal of migration risk; two-factor model required; default correlations based on credit spreads or equity prices; default probability floor of 3bp.
  - Mandatory inclusion of equity and defaulted debt positions.

Highlights

Basel Committee Developments

- Comprehensive risk measure/Standardized specific risk calculation.
  - CRM eliminated with correlation trading portfolio being subject only to standardized approach.
  - Extension of standardized approach to general market risk in U.S.
  - Covers all desks.

Counterparty Risk Implication:

Almost universally higher capital charges for trading book activities and significant operational burdens.

The Securities Markets of the Future: Regulatory Priorities, Trading and Risk Management Practices

Panel: Liquidity and the Future of Fixed Income Market Structure

Chaired by: Lee A. Schneider

April 21, 2016

Debevoise & Plimpton

Panel

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Agenda

- Best Execution – A General Overview
- Best Execution Obligations for Investment Advisers
  - Investment Adviser Obligations: Regulatory Disclosures
  - Investment Adviser Obligations: Enforcement Actions
  - Investment Adviser Obligations: Fiduciary Duties
  - How Investment Advisers Satisfy Best Execution
- FINRA Regulatory Notice 15-46
  - Regulatory Notice 15-46: Equities and Options Best Execution
  - Regulatory Notice 15-46: Fixed Income Best Execution
- Closing Thoughts

Best Execution In General

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Best Execution – A General Overview

- Best execution is generally thought of as an obligation primarily applicable to broker-dealers with respect to trading.
- FINRA Rule 5310 describes the best execution obligation as follows:
  - Using reasonable diligence to ascertain the best market for the security and buying or selling in such market so that the resultant price is as favorable as possible under market conditions. Among the factors considered in determining whether a member used "reasonable diligence" are:
    - » The character of the market for the security (*e.g.*, price, volatility, relative liquidity, and pressure on available communications);
    - » The size and type of transaction;
    - » The number of markets checked;
    - » Accessibility of the quotation; and
    - » The terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

Best Execution – A General Overview Cont’d

- The subjective nature of the best execution factors allows broker-dealers to satisfy the requirement even if the price paid by customers is not the lowest available so long as the relevant facts and circumstances justify the transaction.
- Regulators have traditionally permitted broker-dealers to evaluate best execution on an aggregated basis.
  - FINRA has characterized the appropriate review as “regular and rigorous review of routing and execution arrangements, including what it could have received at other markets.”
- But best execution also applies to investment advisers.

Investment Adviser Requirements

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Best Execution Obligations of Investment Advisers

- The phrase "best execution" does not appear in the Investment Advisers Act of 1940 (the "Advisers Act"). Nonetheless, the SEC has made it clear that investment advisers have best execution obligations under their general fiduciary duties.
- Sources to interpret the obligation include:
  - Required Disclosures on Form ADV;
  - SEC Enforcement Actions;
  - Broker-dealer "best execution" obligations; and
  - Fiduciary duty principles.

Investment Adviser Obligations: Regulatory Disclosures

- Pursuant to the Advisers Act, investment advisers must disclose certain information to their customers. The SEC has used these disclosure requirements to shape the best execution obligation.
  - Form ADV requires investment adviser to describe the factors considered when selecting or recommending broker-dealers for their clients and in determining commissions paid.
  - Registered investment companies are subject to additional disclosure obligations, including required statements of additional information describing brokerage allocations.
  - Advisers also have an obligation to disclose any actual or potential conflicts of interests.

Investment Adviser Obligations: Enforcement Actions

- The SEC has used its enforcement authority to shape the best execution obligations of investment advisors.
  - In 2008, the SEC found that Fidelity violated certain best execution obligations due to receipt of undisclosed travel, gifts, and entertainment from broker-dealers.
  - In 2013, the SEC found that Goelzer Investment Management violated best execution obligations due to discrepancies between the company's statements regarding its execution policies and its actual practices.
- Generally, a takeaway from SEC enforcement related to best execution is that investment advisers need to have legitimate best execution procedures that they follow, particularly with respect to broker selection and compensation.

Investment Adviser Obligations: Fiduciary Duties

- Courts and the SEC have imposed a fiduciary duty on investment advisers to act in the best interest of their clients under the Investment Advisers Act.
- The anti-fraud provisions of Section 206 of such Act have been interpreted to require investment advisers to act in the utmost good faith with respect to clients and to provide full and fair disclosure of all material facts, particularly where an investment adviser's interest may conflict with its clients.

How Investment Advisers Satisfy Best Execution

- Investment advisers are required to execute securities transactions for clients in such a manner that the clients' total costs or proceeds in each transaction are the most favorable under the circumstances.
  - This is not necessarily equivalent to obtaining the lowest price.
- Investment advisers must have processes designed to obtain best execution for client trades given the timing and circumstances. The SEC has indicated the following factors should be considered:
  - Commission rates;
  - Brokers' trading expertise and execution capabilities;
  - The value of research provided; and
  - Access to markets.

How Investment Advisers Satisfy Best Execution

continued

- Investment advisers should engage in certain practices and develop policies and procedures designed to demonstrate efforts to achieve best execution, including:
  - Establishing and maintaining best execution committees;
  - Measuring and regularly reviewing execution quality;
  - Regularly evaluating broker performance and selection;
  - Quantifying the value of research and reviewing commission-sharing agreements; and
  - Periodically reviewing policies, procedures and practices.

FINRA Regulatory Notice 15-46

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FINRA Regulatory Notice 15-46

- On November 20, 2015, FINRA issued Regulatory Notice 15-46: "Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets".
- This notice reiterates many of the long-standing notions about best execution. However, it broke new ground on two fronts:
    1. It introduced the concept of applying an order-by-order analysis of execution quality in certain situations, including for large sized order and for trades executed internally by broker-dealers.
    2. It discussed best execution for fixed-income trades in more detail than previous SEC/FINRA statements, with a focus on electronic trading platforms for these securities.

Regulatory Notice 15-46: Equities and Options Best Execution

- Given developments in order routing technology, FINRA believes order-by-order review of execution quality is increasingly possible for a range of orders in equity securities and standardized options.
- The Notice describes two situations where order-by-order analysis might be appropriate:
  - Block orders; and
  - Internally executed orders.
- FINRA indicated that these requirements stemmed from the use of trading and transaction cost analysis technologies.
- FINRA did not make clear what exactly would be required conducting this analysis or what considerations should apply in reviewing each executed order.

Fixed Income Best Execution

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Regulatory Notice 15-46: Fixed Income Best Execution – Background on Pricing

- As electronic trading systems proliferate, firms need to determine whether to use such systems both to meet best execution obligations and in determining how to review for best execution when using those systems.
- Firms should routinely analyze whether pricing information from electronic trading systems should be incorporated into their best execution policies and procedures due to their increased pre-trade transparency .
- FINRA recognizes different systems provide different levels of price information and execution functionality.
- Broker-dealers must evaluate each electronic system on its own merits. For example, as part of best execution analysis, a firm exclusively using an auto-execution system should lead a firm to analyze pricing information from other systems (including manual options).

Regulatory Notice 15-46: Fixed Income Best Execution – Facts and Circumstances Analysis

- FINRA notes that determining best execution can be nuanced for fixed income securities because:
  - prices displayed on an electronic trading platform may not be the presumptive best price of that security, especially for securities that are illiquid or trade infrequently, and
  - there can be significant variations in trading and liquidity depending on the specific fixed income product.
- As with equities, broker-dealers must use a "facts and circumstances" analysis to ascertain the best market for the security and to trade at a price to the customer as favorable as reasonably possible under prevailing market conditions.
- The key determinant is the character of the market for the specific security, including price, volatility, and relative liquidity, which might mean review of execution quality may be less frequent than that of equities or options.

Regulatory Notice 15-46: Fixed Income Best Execution – Supplemental Materials

- The Notice also references previously released FINRA Supplemental Materials stating that:
  - Accessibility of quotations is one of a non-exhaustive list of factors in assessing best execution such that broker-dealers are not relieved of responsibility simply because they cannot access a quotation; and
  - Firm’s execution policies and procedures must discuss handling situations where there is limited quote and pricing information for a security.

Regulatory Notice 15-46: Fixed Income Best Execution – Requirements under Rule 5310

- In discussing the reasonably diligence factors set out in Rule 5310, FINRA notes that the duty of best execution does not necessarily require a firm to access every available platform. For example, a firm need not post a "bid wanted" on each RFQ platform.
- Notice 15-46 lists several requirements:
  - Evaluate execution quality of venues that a firm has access to and, to the extent information is reasonably available, regularly assess whether to join other venues.
  - Have policies and procedures for determining when to use electronic versus manual liquidity in seeking to execute a customer order.
  - Compare the quality of executions obtained for customers via current order routing and execution arrangements to the quality of those that could be obtained from competing markets.

Regulatory Notice 15-46: Fixed Income Best Execution – Extreme Market Conditions 1

- Broker-dealers should consider implementing procedures designed to execute customer orders consistent with best execution even during extreme market conditions (e.g., liquidity shortage, divergent prices during ratings changes or interest rate movements).
- FINRA provides guidelines for executing trades during extreme market conditions, as discussed on the next slide.
- Ultimately, however, FINRA notes that a facts and circumstances analysis is necessary to determine whether actions taken by a firm during extreme market conditions are consistent with the duty of best execution.

Regulatory Notice 15-46: Fixed Income Best Execution - Extreme Market Conditions 2

- The guidelines for extreme market conditions include:
  - The treatment of customer orders must remain fair, consistent, and reasonable.
  - To the extent that a firm's order handling procedures are different during extreme market conditions, the firm should disclose to its customers the differences from normal market trading and the circumstances when such procedures apply.
  - Procedures for extreme market conditions should be activated only when warranted by market conditions. Accordingly, firms should document the basis for activation of their modified procedures.

Closing Thoughts

Closing Thoughts

- As Regulatory Notice 15-46 makes clear, best execution obligations will continue to evolve as technology evolves. Consequently, firms should make sure to reevaluate their best execution procedures as new technologies come on line, either internal or external systems.
- It is not necessarily clear what “order-by-order” best execution analysis means or entails. Firms should consider what this obligations means to them but also the various options for what it may mean to FINRA.
- Both broker-dealers and investment advisers should remain cognizant of SEC enforcement actions related to best execution for guidance as to current expectations as well as the best roadmap for the future.

Client Update

FinCEN Issues New Rule Requiring Identification of Beneficial Owners and Risk-Based Customer Due Diligence

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On May 11, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") published in the *Federal Register* a final rule expanding customer due diligence ("CDD") requirements for certain "covered financial institutions."[1] The final rule will impose two new, and significant, requirements on covered financial institutions:

- **First**, it will require covered financial institutions to establish procedures to identify, and verify the identity of, the beneficial owners of legal entity customers that open new accounts, unless there is an exception.
- **Second**, it will add a "fifth pillar" to existing anti-money laundering ("AML") program requirements. Currently, AML programs have four pillars – policies and procedures; a designated AML compliance officer; testing; and training. The final rule adds to these program requirements by mandating risk-based procedures for conducting on-going customer diligence to understand the nature and purpose of the customer relationship.

The final rule is part of a larger package of reforms introduced by the Obama Administration to respond to issues such as money laundering, tax evasion and foreign corruption, highlighted by the so-called Panama Papers. These efforts include proposed amendments to the Bank Secrecy Act ("BSA") that would require all U.S. companies to report beneficial ownership information to the federal government, and changes to Internal Revenue Service ("IRS") regulations to mandate that certain companies, particularly single-owner limited liability companies, receive an employer identification number ("EIN") and submit to tax assessments. In addition, the U.S. Justice Department has proposed amendments

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[1] 81 Fed. Reg. 29398 (May 11, 2016).

to existing laws to enhance the ability of law enforcement to pursue money laundering and corruption cases.

Below, we first review the new final rule and its requirements. We then describe the other Obama Administration efforts.

I. FINCEN'S NEW REQUIREMENTS

Which Entities Must Comply with the Final Rule?

As noted, the final rule applies to "covered financial institutions," which refers to:

- Banks, including insured depository institutions, federally regulated trust companies, the U.S. agencies and branches of foreign banks and Edge Act corporations;
- Securities broker-dealers;
- Mutual funds; and
- Futures commission merchants and introducing brokers in commodities.[2]

What Is the Date by Which Covered Financial Institutions Need to Comply with the Final Rule?

The final rule takes effect on May 11, 2018 (the "Applicability Date"), and applies to new accounts opened by covered financial institutions on or after that date. FinCEN delayed the Applicability Date in response to public comments, which identified the wide range of systems and process changes required to comply with the new rule.

FinCEN also specifically declined to make the requirements retroactively applicable, acknowledging that such a mandate "would be unduly burdensome." That said, FinCEN does not allow covered financial institutions to ignore pre-existing accounts and customer relationships entirely; rather, FinCEN cautions that covered financial institutions "should obtain beneficial ownership information from customers existing on the Applicability Date when, in the course of their normal monitoring, the financial institution detects information relevant to assessing or reevaluating the risk of such customer."

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2 On September 1, 2015, FinCEN published a proposal in the *Federal Register* to require investment advisers registered with the Securities and Exchange Commission (the "SEC") to adopt AML programs and report suspicious activities. *See* Debevoise Client Update, FinCEN Proposes Anti-Money Laundering Rules for Investment Advisers (Aug. 31, 2015). The proposal did not seek to apply customer identification program ("CIP") requirements to SEC-registered investment advisers and, presumably, that would be a predicate step before FinCEN sought to extend this CDD requirement to advisers.

What Are the Beneficial Ownership Requirements of the Final Rule?

The final rule requires covered financial institutions to maintain written procedures to identify and verify the identity of each natural person who qualifies as a beneficial owner of a legal entity customer, subject to certain exceptions (as discussed below).

Legal Entity Customer. The final rule generally defines a legal entity customer as (i) a corporation, limited liability company or other entity created by the filing of a public document with a Secretary of State or similar office, (ii) a general partnership or (iii) any similar entity formed under the laws of a foreign jurisdiction. The preamble to the final rule notes that this definition includes limited partnerships and business trusts created by a filing with a state office, but it does not include sole proprietorships or unincorporated associations.[3]

Beneficial Owner. Individuals need to be identified as beneficial owners if they meet either of two tests established by the final rule.

- *Ownership Prong*: each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of the legal entity customer; and
- *Control Prong*: a single individual with significant responsibility to control, manage or direct a legal entity customer, such as a CEO, CFO, managing partner or other individual who performs similar functions.

Accordingly, the maximum number of beneficial owners that the final rule requires to be collected for each legal entity customer is five; however, that number will vary from customer to customer. For legal entity customers with dispersed ownership, for example, there may be only one beneficial owner, under the Control Prong. We note some possible scenarios in Appendix A.

In general, covered financial institutions may rely on information supplied by legal entity customers regarding their direct and indirect beneficial owners. To this end, FinCEN makes clear that covered financial institutions must verify the *identity* of beneficial owners (i.e., verify the individual's existence) but not his or her *status* as a beneficial owner of the legal entity customer. That said, the final rule also cautions that reliance may not be appropriate if a covered financial

3 Trusts, with the exception of certain statutory trusts that require a filing with a state office, are not legal entity customers; regardless, FinCEN notes that existing supervisory guidance applicable to banking institutions and broker-dealers may require the institution to look through such trusts to obtain information about persons who control the trust in order to learn that the true identity of the customer.

institution "has knowledge of facts that would reasonably call into question the reliability" of beneficial ownership information provided by a legal entity customer. It therefore remains to be seen how examiners will apply this knowledge standard and whether this language, over time, will result in higher supervisory expectations than the rule arguably imposes.

One area of potential difficulty may be the determination of indirect, or ultimate, beneficial owners. For example, FinCEN reiterates, when discussing comments raised about the identification of indirect beneficial owners, that "financial institutions will generally be able to rely on the representations of the customer when it identifies its beneficial owners," but FinCEN also notes that "the financial institution's customer [must] identify its ultimate beneficial owner or owners as defined in the rule and not their nominees or 'straw men.'" FinCEN declined to provide additional guidance on the responsibilities of covered financial institutions to identify indirect beneficial owners, nor did the agency offer guidance on what factors might trigger the knowledge standard described above such that a covered financial institution could not reasonably rely on a customer's representations.

What Identification and Verification Steps Need Be Taken with Respect to Beneficial Owners of Legal Entity Customers?

At the time of opening a new account for a legal entity customer, covered financial institutions must (a) collect information to identify each natural person who is a beneficial owner and then (b) verify the identity of that natural person.

To identify a beneficial owner, the final rule provides a choice between using a standard form, included as an appendix to the rule, or another means to obtain the same information required by the form, provided that the individual opening the legal entity customer's account certifies, to the best of his or her knowledge, as to the accuracy of the information.[4] A corporate officer or other representative of the legal entity customer may complete this information on behalf of a beneficial owner.

The final rule also directs covered financial institutions to verify the identity of each beneficial owner "according to risk-based procedures to the extent reasonable and practicable." The final rule states that, at a minimum, these

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[4] FinCEN had originally proposed requiring the use of a standard certification form; in response to public comments, FinCEN has determined to allow (but not require) the use of a standard form. Appendix B provides a redline comparison of the final rule to the proposed rule.

verification procedures must contain the elements required under applicable CIP regulations, with an important distinction – a covered financial institution may use photocopies or other reproductions of original documents for documentary verification purposes.

Records of identification information must be maintained for at least five years after the account is closed, and records collected for verification purposes must be maintained for five years after the record is made.

Are There Exceptions to the Look-Through Requirements?

Yes; 16 categories of legal entity customers are wholly excluded from the requirement to identify beneficial owners, and two categories of customers are partially excluded.[5]

The following are among those categories of legal entity customers wholly excluded from the rule's requirements:

- *Financial institutions* regulated by a federal functional regulator or a bank regulated by a state bank regulator;
- *Certain U.S. and non-U.S. governmental entities*;
- *Public companies* with stock listed on the New York, American or NASDAQ stock exchange;
- *Investment companies*, *investment advisers* and other entities registered with the SEC;
- *Certain entities* registered with the Commodity Futures Trading Commission;
- *Pooled investment vehicles*, including private funds, operated or advised by an entity excluded under the final rule, such as an SEC-registered investment adviser;
- *Insurance companies* subject to state regulation;
- *Financial market utilities* designated by the Financial Stability Oversight Council; and
- *Foreign financial institutions* established in a jurisdiction where the home-country regulator maintains beneficial ownership information on the institution.

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5 In addition, certain types of account relationships are excluded because FinCEN believes that they present low risks for money laundering. For example, FinCEN exempts from the beneficial ownership requirements private-label credit card accounts established at the retail point of sale.

Certain legal entity customers are partially excluded. Those customers are subject only to the Control Prong of the final rule.

- *Pooled investment vehicles* operated or advised by a financial institution not excluded under the final rule, such as certain foreign funds; and
- *Nonprofit corporations* or similar entities that have filed organizational documents with the appropriate U.S. state authority.

What Are Covered Financial Institutions Expected to Do with Beneficial Ownership Information?

FinCEN expects covered financial institutions to use the beneficial ownership information to ensure compliance with other requirements. For example, FinCEN directs covered financial institutions to use beneficial ownership information to screen against the Specially Designated Nationals and Blocked Persons List maintained by the U.S. Treasury's Office of Foreign Assets Control ("OFAC"). FinCEN also recommends covered financial institutions develop risk-based procedures to determine whether beneficial owners should be screened through negative news searches as well as to consider whether the information is relevant to Currency Transaction Reporting requirements.

As a result, covered financial institutions will be expected to integrate beneficial ownership information into their AML, sanctions and other compliance-oriented systems and processes. Thus, the costs to covered financial institutions will not only be the development of new procedures and systems to capture and store beneficial ownership information but also costs necessary to ensure integration with other policies and systems.

What Are the New Risk-Based Due Diligence Requirements, Established as the "Fifth Pillar" of AML Programs?

In addition to requiring covered financial institutions to collect beneficial ownership information about legal entity customers, FinCEN also expanded the AML program requirement for covered financial institutions. Specifically, as noted above, FinCEN adds a new "fifth pillar" to existing AML program requirements and mandates "risk-based procedures for conducting ongoing customer due diligence," including:

- <u>Customer Risk Profile</u>: to understand the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and
- <u>Monitor and Update</u>: to maintain and update customer information, including beneficial ownership information for legal entity customers, on a risk basis as part of identifying and reporting suspicious activities.

With respect to the customer risk profile, FinCEN states that the requirement is to gather information about a customer at account opening to develop “a baseline against which customer activity is assessed for suspicious activity reporting.” FinCEN states that the obligation to update customer information generally would only be triggered when a covered financial institution, in the course of normal account monitoring, discovers information relevant to assessing the risk posed by the customer; FinCEN notes that it does not intend “to impose a categorical requirement to update customer or beneficial ownership information on a continuous or ongoing basis.”

FinCEN emphasizes that this fifth pillar reflects “nothing more than an explicit codification of existing expectations” rather than creating new obligations. To this end, FinCEN indicates the rule is designed merely to make explicit existing regulatory expectations regarding customer due diligence and to harmonize requirements across the financial sector.

It remains to be seen whether supervisory expectations will vary from FinCEN’s assurances and whether this fifth pillar will create new sources of enforcement risk. It seems highly likely that the new fifth pillar will create new compliance burdens: in designing and implementing procedures and controls to give effect to the final rule, covered financial institutions will be required, *in many cases for the first time*, to consider what circumstances should be the target of ongoing monitoring systems and which events should spur the collection of updated customer and beneficial ownership information.

Moreover, while (as noted above) the beneficial ownership requirement will apply to new accounts opened on or after May 11, 2018, the fifth pillar effectively may require covered financial institutions to conduct additional diligence on current accounts as well. Without doing so, institutions may not have adequate customer risk profiles for their existing customers.

II. RELATED DEVELOPMENTS

As noted above, the final rule represents one aspect of a multi-pronged effort on the part of the Administration to address money laundering and related issues. As part of this effort, both the U.S. Treasury and Justice Departments announced new measures.

U.S. Treasury Department

Contemporaneous to announcing the final CDD rule, the U.S. Treasury Department announced that it would submit new beneficial ownership legislation to Congress. The legislation would require all U.S. companies, at the time of their creation, to file beneficial ownership information with the Treasury Department or face penalties for failure to comply.

The Treasury Department also has proposed new regulations to require certain foreign-owned entities, such as single-member limit liability companies, to obtain an employer identification number ("EIN") from the IRS. This requirement would permit the IRS to determine whether these entities are being used to evade U.S. taxes. The Treasury Department also intends to use this requirement to gather information to share with non-U.S. tax authorities in furtherance of the United States' commitments to foreign governments related to the Foreign Account Tax Compliance Act ("FATCA"). To that end, Treasury Secretary Lew called on Congress to approve tax treaties that have been under consideration for years and bring the United States into line with international standards on tax information sharing.

Additionally, the U.S. Treasury, through FinCEN, is reviewing information gained from Geographic Targeting Orders ("GTOs") requiring the collection of beneficial ownership information for legal entities making cash purchases of high-value residential property in Miami and New York City. Based on this data, FinCEN may broaden the GTOs to other areas or propose a more comprehensive rulemaking.

U.S. Justice Department

The Justice Department also announced proposed legislation to expand its capacity to focus law enforcement resources on money laundering and corruption issues. Among these proposals are a call to revise federal money laundering and corruption offenses to complement the ability of federal prosecutors to charge international money launderers and fight international corruption.

Also announced or proposed are changes to obtaining bank and other records in money laundering investigations. The Justice Department has requested amendments to current law that would allow administrative, rather than grand jury, subpoenas to obtain records in money laundering investigations and changes to the BSA to increase the utility of subpoenaing U.S. branches of foreign banks in order to obtain foreign bank records.

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Please contact any of the authors for additional information. In addition, for e-mail updates on sanctions and related money laundering developments, please subscribe to the Debevoise & Plimpton Sanctions Alert, a monthly summary of developments in economic and trade sanctions. To subscribe, please e-mail sanctions@debevoise.com or sign up at the Insights Subscribe Page on our website. The Firm's sanctions-related publications may also be found at The Sanctions Resource page on our website.

Appendix A – Application of the Beneficial Ownership Rule

Scenario 1 – Four individuals own 25% each of a legal entity customer

- Five beneficial owners - The covered financial institution must collect beneficial ownership for the four owners AND a control person (assuming that the control person is different from the owners).

Scenario 2 – No individual owns 25% or more of a legal entity customer

- One beneficial owner. The covered financial institution must collect beneficial ownership information for ONLY a control person.

Scenario 3 – Company A owns 25% of the legal entity customer

- At least one beneficial owner. The covered financial institution must collect beneficial ownership information for a control person AND any natural person who owns, directly or indirectly, 25% or more of Company A (*i.e.*, the covered financial institution must look through the company to determine whether there is a natural person who indirectly owns 25% or more of the legal entity customer).

Scenario 4 – A covered financial institution opens an intermediated account, such as an omnibus account, for a legal entity customer

- In accordance with existing guidance under the CIP requirements, the covered financial institution would identify and verify the beneficial owners of the customer opening the intermediated account but would not be obligated to look through an intermediated account (*i.e.*, the covered financial institution would not be required to seek beneficial ownership information on its customer's customer in these circumstances).

Scenario 5 – The legal entity customer is a non-U.S. investment fund

- If the non-U.S. investment fund is not operated or advised by an excluded entity, such as an SEC-registered investment adviser, the covered financial institution must collect beneficial ownership information only for a control person (*i.e.*, a partial exclusion from the final rule).

Appendix B – Redline of Proposed and Final Rule

PART 1010—GENERAL PROVISIONS

1. The authority citation for part 1010 continues to read as follows:

Authority: 12 U.S.C. 1829b and 1951-1959; 31 U.S.C. 5311-5314 and 5316-5332; title III, sec. 314 Pub. L. 107-56,115 Stat. 307.

2. Add § 1010.230 ~~in subpart B~~ to read as follows:

§ 1010.230 Beneficial ownership requirements for legal entity customers.

(a) In general. Covered financial institutions are required to establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of legal entity customers and to include such procedures in their anti-money laundering compliance program required under 31 U.S.C. 5318(h) and its implementing regulations.

(b) Identification and verification. With respect to legal entity customers, the covered financial institution's customer due diligence procedures ~~should~~shall enable the institution to:

(1) Identify the beneficial owner(s) of each legal entity customer~~, unless otherwise exempt pursuant to paragraph (d) of this section. To identify the beneficial owner(s), a covered financial institution must obtain~~ at the time a new account is opened, unless the customer is otherwise excluded pursuant to paragraph (e) of this section or the account is exempted pursuant to paragraph (h) of this section. A covered financial institution may accomplish this either by obtaining a certification in the form of ~~Appendix~~appendix A of this section from the individual opening the account on behalf of the legal entity customer, or by obtaining from the individual the information required by the form by another means, provided the individual certifies, to the best of the individual's knowledge, the accuracy of the information; and

(2) Verify the identity of each beneficial owner identified to the covered financial institution, according to risk-based procedures to the extent reasonable and practicable. At a minimum, these procedures must ~~be identical to the covered financial institution's Customer Identification Program procedures~~contain the elements required for verifying the identity of customers that are individuals under §1020.220(a)(2) of this chapter (for banks); §1023.220(a)(2) of this chapter (for brokers or dealers in securities); §1024.220(a)(2) of this chapter (for mutual funds); or §1026.220(a)(2) of this chapter (for futures commission merchants or introducing brokers in commodities)~~.~~; provided, that in the case of documentary verification, the financial institution may use photocopies or other reproductions of the documents listed in paragraph (a)(2)(ii)(A)(1) of §1020.220 of this chapter (for banks); §1023.220 of this chapter (for brokers or dealers in securities); §1024.220 of this chapter (for mutual funds); or §1026.220 of this chapter (for futures

commission merchants or introducing brokers in commodities). A covered financial institution may rely on the information supplied by the legal entity customer regarding the identity of its beneficial owner or owners, provided that it has no knowledge of facts that would reasonably call into question the reliability of such information.

(c) Account. For purposes of this section, account has the meaning set forth in §1020.100(a) of this chapter (for banks); §1023.100(a) of this chapter (for brokers or dealers in securities); §1024.100(a) of this chapter (for mutual funds); and §1026.100(a) of this chapter (for futures commission merchants or introducing brokers in commodities).

(~~c~~d) Beneficial owner. For purposes of this section, ~~Beneficial Owner~~beneficial owner means each of the following:

(1) Each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25~~%~~ percent or more of the equity interests of a legal entity customer; and

(2) A single individual with significant responsibility to control, manage, or direct a legal entity customer, including:

(i) An executive officer or senior manager (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer); or

(ii) Any other individual who regularly performs similar functions.

(3) If a trust owns directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, 25 percent or more of the equity interests of a legal entity customer, the beneficial owner for purposes of paragraph (d)(1) of this section shall mean the trustee. If an entity listed in paragraph (e)(2) of this section owns directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, 25 percent or more of the equity interests of a legal entity customer, no individual need be identified for purposes of paragraph (d)(1) of this section with respect to that entity's interests.

Note to paragraph (~~c~~d)~~:~~. The number of individuals that satisfy the definition of "beneficial owner," and therefore must be identified and verified pursuant to this 208 section, may vary. Under paragraph (~~c~~d)(1) of this section, depending on the factual circumstances, up to four individuals may need to be identified. Under paragraph (~~c~~d)(2) of this section, only one individual must be identified. It is possible that in some circumstances the same person or persons might be identified pursuant to paragraphs (~~c~~d)(1) and (2) of this section. A covered financial institution may also identify additional individuals as part of its customer due diligence if it deems appropriate on the basis of risk.

(~~d~~e) Legal entity customer. For the purposes of this section~~,~~:

(1) Legal entity customer means~~: A~~ a corporation, limited liability company, ~~partnership or other similar business entity (whether~~or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a ~~state or of the United States or a~~ foreign jurisdiction~~)~~ that opens ~~a new~~an account.

(2) Legal entity customer does not include:

(i) A financial institution regulated by a Federal functional regulator or a bank regulated by a State bank regulator;

(ii) A person described in § 1020.315(b)(2) through (5) of this chapter;

(iii) An issuer of a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of that Act;

(iv) An investment company, as defined in section 3 of the Investment Company Act of 1940, that is registered with the Securities and Exchange Commission under that Act;

(v) An investment adviser, as defined in section 202(a)(11) of the Investment Advisers Act of 1940, that is registered with the Securities and Exchange Commission under that Act;

(vi) An exchange or clearing agency, as defined in section 3 of the Securities Exchange Act of 1934, that is registered under section 6 or 17A of ~~the Securities Exchange Act of~~ that Act;

(vii) Any other entity registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934;

(viii) A registered entity, commodity pool operator, commodity trading advisor, retail foreign exchange dealer, swap dealer, or major swap participant, each as defined in section la of the Commodity Exchange Act, that is registered with the Commodity Futures Trading Commission;

(ix) A public accounting firm registered under section 102 of the Sarbanes-Oxley Act;~~ and~~

(x) A ~~charity or nonprofit entity that is described in sections 501(c), 527, or 4947(a)(1) of the Internal Revenue Code of 1986, has not been denied tax exempt status, and is required to and has filed the most recently due annual information return with the Internal Revenue Service.~~bank holding company, as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) or savings and loan holding company, as defined in section 10(n) of the Home Owners' Loan Act (12 U.S.0 1467a(n));

(xi) A pooled investment vehicle that is operated or advised by a financial institution excluded under paragraph (e)(2) of this section;

(xii) An insurance company that is regulated by a State;

(xiii) A financial market utility designated by the Financial Stability Oversight Council under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010;

(xiv) A foreign financial institution established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution;

(xv) A non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities; and

(xvi) Any legal entity only to the extent that it opens a private banking account subject to §1010.620 of this chapter.

(3) The following legal entity customers are subject only to the control prong of the beneficial ownership requirement:

(i) A pooled investment vehicle that is operated or advised by a financial institution not excluded under paragraph (e)(2) of this section; and

(ii) Any legal entity that is established as a nonprofit corporation or similar entity and has filed its organizational documents with the appropriate State authority as necessary.

(~~e~~f) Covered financial institution. For the purposes of this section, covered financial institution has the meaning set forth in § 1010.605(e)(1) of this chapter.

(g) New account. For the purposes of this section, new account means each account opened at a covered financial institution by a legal entity customer on or after the applicability date.

(h) Exemptions. (1) Covered financial institutions are exempt from the requirements to identify and verify the identity of the beneficial owner(s) set forth in paragraphs (a) and (b)(1) and (2) of this section only to the extent the financial institution opens an account for a legal entity customer that is:

(i) At the point-of-sale to provide credit products, including commercial private label credit cards, solely for the purchase of retail goods and/or services at these retailers, up to a limit of $50,000;

(ii) To finance the purchase of postage and for which payments are remitted directly by the financial institution to the provider of the postage products;

(iii) To finance insurance premiums and for which payments are remitted directly by the financial institution to the insurance provider or broker;

(iv) To finance the purchase or leasing of equipment and for which payments are remitted directly by the financial institution to the vendor or lessor of this equipment.

(2) Limitations on Exemptions. (i) The exemptions identified in paragraphs (h)(1)(ii) through (iv) of this section do not apply to transaction accounts through which a legal entity customer can make payments to, or receive payments from, third parties.

(ii) If there is the possibility of a cash refund on the account activity identified in paragraphs (h)(1)(ii) through (iv) of this section, then beneficial ownership of the legal entity customer must be identified and verified by the financial institution as required by this section, either at the time of initial remittance, or at the time such refund occurs.

(~~f~~i) Recordkeeping. A covered financial institution must establish procedures for making and maintaining a record of all information obtained under the procedures implementing paragraph (b) of this section.

(1) Required records. At a minimum the record must include:

(i) For identification, ~~the certification form described in paragraph (b) of this section, and any other~~any identifying information obtained by the covered financial institution pursuant to paragraph (b) of this section, including without limitation the certification (if obtained); and

(ii) For verification, a description of any document relied on (noting the type, any identification number, place of issuance and~~;~~, if any, date of issuance and expiration), of any non-documentary methods and the results of any measures undertaken, and of the resolution of each substantive discrepancy.

(2) Retention of records. A covered financial institution must retain the records made under paragraph (~~f~~i)(1)(i) of this section for five years after the date the account is closed, and the records made under paragraph (~~f~~i)(1)(ii) of this section for five years after the record is made.

(~~g~~j) Reliance on another financial institution. A covered financial institution may rely on the performance by another financial institution (including an affiliate) of the requirements of this section with respect to any legal entity customer of the covered financial institution that is opening, or has opened, an account or has established a similar business relationship with the other financial institution to provide or engage in services, dealings, or other financial transactions, provided that:

(1) Such reliance is reasonable under the circumstances;

(2) The other financial institution is subject to a rule implementing 31 U.S.C. 5318(h) and is regulated by a Federal functional regulator; and

(3) The other financial institution enters into a contract requiring it to certify annually to the covered financial institution that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) the specified requirements of the covered financial institution's procedures to comply with the requirements of this section.

APPENDIX ~~A--CERTIFICATION~~A to § 1010.230 — CERTIFICATION REGARDING BENEFICIAL OWNERS OF LEGAL ENTITY CUSTOMERS

I. GENERAL INSTRUCTIONS

What is this form?

To help the government fight financial crime, ~~federal~~Federal regulation requires certain financial institutions to obtain, verify, and record information about the beneficial owners of legal entity customers. Legal entities can be abused to disguise involvement in terrorist financing, money laundering, tax evasion, corruption, fraud, and other financial crimes. Requiring the disclosure of key individuals who ~~ultimately~~ own or control a legal entity (i.e., the beneficial owners) helps law enforcement investigate and prosecute these crimes.

Who has to complete this form?

This form must be completed by the person opening a new account on behalf of a legal entity with any of the following U.S. financial institutions: (i) ~~A~~a bank or credit union; (ii) a broker or dealer in securities; (iii) a mutual fund; (iv) a futures commission merchant; or (v) an introducing broker in commodities.

For the purposes of this form, a legal entity includes a corporation, limited liability company, or other entity that is created by a filing of a public document with a Secretary of State or similar office, a general partnership, and any ~~other~~ similar business entity formed in the United States or a foreign country. Legal entity does not include sole proprietorships, unincorporated associations, or natural persons opening accounts on their own behalf.

What information do I have to provide?

This form requires you to provide the name, address, date of birth and ~~social security~~Social Security number (or passport number or other similar information, in the case of foreign persons) for the following individuals (i.e., the beneficial owners):

(i) Each individual, if any, who owns, directly or indirectly, 25 percent or more of the equity interests of the legal entity customer (e.g., each natural person that owns 25 percent or more of the shares of a corporation); and

(ii) An individual with significant responsibility for managing the legal entity customer (e.g., a Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, or Treasurer).

The number of individuals that satisfy this definition of "beneficial owner" may vary. Under section (i), depending on the factual circumstances, up to four individuals (but as few as zero) may need to be identified. Regardless of the number of individuals identified under section (i), you must provide the identifying information of one individual under section (ii). It is possible that in some circumstances the same individual might be identified under both sections (e.g., the President of Acme, Inc. who also holds a 30% equity interest). Thus, a completed form will contain the identifying information of at least one individual (under section (ii)), and up to five individuals (i.e., one individual under section (ii) and four 25 percent equity holders under section (i)).

The financial institution may also ask to see a copy of a driver's license or other identifying document for each beneficial owner listed on this form.

~~BILLING CODE 4810-02-P~~

II. CERTIFICATION OF BENEFICIAL OWNER(S)

Persons opening an account on behalf of a legal entity must provide the following information:

a. Name and Title of Natural Person Opening Account:

b. Name and Address of Legal Entity for Which the Account is Being Opened:

c. The following information for each individual, if any, who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25 percent or more of the equity interests of the legal entity listed above:

~~(If no individual meets this definition, please write "Not Applicable.")~~

Name	Date of Birth	Address (Residential or Business Street Address)	For U.S. Persons: Social Security Number	For Foreign Persons: Passport Number and Country of Issuance, or other similar identification number[1]

(If no individual meets this definition, please write “Not Applicable.”)

d. The following information for one individual with significant responsibility for managing the legal entity listed above, such as:

- An executive officer or senior manager (e.g., Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Managing Member, General Partner, President, Vice President, Treasurer); or

- Any other individual who regularly performs similar functions.

(If appropriate, an individual listed under section (c) above may also be listed in this section (d)).

Name/Title	Date of Birth	Address (Residential or Business Street Address)	For U.S. Persons: Social Security Number	For Foreign Persons: Passport Number and Country of Issuance, or other similar identification number[1]

~~1~~I, ______________________ (name of natural person opening account), hereby certify, to the best of my knowledge, that the information provided above is complete and correct.

Signature: Date:

[1]In lieu of a passport number, foreign persons may also provide an alien identification card number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

Legal Entity Identifier (Optional)

PART 1020—RULES FOR BANKS

3. The authority citation for part 1020 continues to read as follows:

Authority: 12 U.S.C. 1829b and 1951-1959; 31 U.S.C. 5311-5314 and 5316-5332; title III, sec. 314 Pub. L. 107-56,115 Stat. 307.

4. Revise § 1020.210 ~~in subpart B~~ to read as follows:

§1020.210 Anti-money laundering program requirements for financial institutions regulated only by a Federal functional regulator, including banks, savings associations, and credit unions.

A financial institution regulated by a Federal functional regulator that is not subject to the regulations of a self-regulatory organization shall be deemed to satisfy the requirements of 31 U.S.C. 5318(h)(1) if the financial institution implements and maintains an anti-money laundering program that:

(a) Complies with the requirements of §§ 1010.610 and 1010.620 of this chapter;

(b) Includes, at a minimum~~:~~•

(1) A system of internal controls to assure ongoing compliance;

(2) Independent testing for compliance to be conducted by bank personnel or by an outside party;

(3) Designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance;

(4) Training for appropriate personnel; and

(5) Appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:

(i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and

(ii) Conducting ongoing monitoring to ~~maintain and update customer information and to~~ identify and report suspicious transactions~~; and~~ and, on a risk basis, to maintain and update customer information. For purposes of this paragraph (b)(5)(ii), customer information shall include information regarding the beneficial owners of legal entity customers (as defined in §1010.230 of this chapter); and

(c) Complies with the regulation of its Federal functional regulator governing such programs.

PART 1023—RULES FOR BROKERS OR DEALERS IN SECURITIES

5. The authority citation for part 1023 continues to read as follows:

Authority: 12 U.S.C. 1829b and 1951-1959; 31 U.S.C. 5311-5314 and 5316-5332; title III, sec. 314 Pub. L. 107-56,115 Stat. 307.

6. Revise § 1023.210 ~~in subpart B~~ to read as follows:

§1023.210 Anti-money laundering program requirements for brokers or dealers in securities.

A broker or dealer in securities shall be deemed to satisfy the requirements of 31 U.S.C. 5318(h)(1) if the broker-dealer implements and maintains a written anti-money laundering program approved by senior management that:

(a) Complies with the requirements of §§ 1010.610 and 1010.620 of this chapter and any applicable regulation of its Federal functional regulator governing the establishment and implementation of anti-money laundering programs;

(b) Includes, at a minimum~~:~~:

(1) The establishment and implementation of policies, procedures, and internal controls reasonably designed to achieve compliance with the applicable provisions of the Bank Secrecy Act and the implementing regulations thereunder;

(2) Independent testing for compliance to be conducted by the broker-dealer's personnel or by a qualified outside party;

(3) Designation of an individual or individuals responsible for implementing and monitoring the operations and internal controls of the program;

(4) Ongoing training for appropriate persons; and

(5) Appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:

(i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and

(ii) Conducting ongoing monitoring to ~~maintain and update customer information and to~~ identify and report suspicious transactions~~; and~~ and, on a risk basis, to maintain and update customer information. For purposes of this paragraph (b)(5)(ii), customer information shall include information regarding the beneficial owners of legal entity customers (as defined in §1010.230 of this chapter); and

(c) Complies with the rules, regulations, or requirements of its self-regulatory organization governing such programs; provided that the rules, regulations, or requirements of the self-regulatory organization governing such programs have been made effective under the Securities Exchange Act of 1934 by the appropriate Federal functional regulator in consultation with FinCEN.

PART 1024—RULES FOR MUTUAL FUNDS

7. The authority citation for part 1024 continues to read as follows:

Authority: 12 U.S.C. 1829b and 1951-1959; 31 U.S.C. 5311-5314 and 5316-5332; title III, sec. 314 Pub. L. 107-56,115 Stat. 307.

8. Revise § 1024.210 ~~in subpart B~~ to read as follows:

§1024.210 Anti-money laundering program requirements for mutual funds.

(a) Effective July 24, 2002, each mutual fund shall develop and implement a written anti-money laundering program reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve and monitor compliance with the applicable requirements of the Bank Secrecy Act (31 U.S.C. 5311, et seq.), and the implementing regulations promulgated thereunder by the Department of the Treasury. Each mutual fund's anti-money laundering program must be approved in writing by its board of directors or trustees. A mutual fund shall make its anti-money laundering program available for inspection by the U.S. Securities and Exchange Commission.

(b) The anti-money laundering program shall at a minimum:

(1) Establish and implement policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of the Bank Secrecy Act and implementing regulations thereunder;

(2) Provide for independent testing for compliance to be conducted by the mutual fund's personnel or by a qualified outside party;

(3) Designate a person or persons responsible for implementing and monitoring the operations and internal controls of the program;

~~(4) Provide ongoing training for appropriate personnel; and~~

(~~5~~4) Implement appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:

(i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and

(ii) ~~conducting~~Conducting ongoing monitoring ~~to maintain and update customer information and~~ to identify and report suspicious transactions~~.~~ and, on a risk basis, to maintain and update customer information. For purposes of this paragraph (b)(4)(ii), customer information shall include information regarding the beneficial owners of legal entity customers (as defined in §1010.230 of this chapter).

PART 1026—RULES FOR FUTURES COMMISSION MERCHANTS AND

INTRODUCING BROKERS IN COMMODITIES

9. The authority citation for part 1026 continues to read as follows:

Authority: 12 U.S.C. 1829b and 1951-1959; 31 U.S.C. 5311-5314 and 5316-5332; title III, sec. 314 Pub. L. 107-56,115 Stat. 307.

10. Revise § 1026.210 ~~in subpart B~~ to read as follows:

§1026.210 Anti-money laundering program requirements for futures commission merchants and introducing brokers in commodities.

A futures commission merchant and an introducing broker in commodities shall be deemed to satisfy the requirements of 31 U.S.C. 5318(h)(1) if the futures commission merchant or introducing broker in commodities implements and maintains a written anti-money laundering program approved by senior management that:

(a) Complies with the requirements of §§ 1010.610 and 1010.620 of this chapter and any applicable regulation of its Federal functional regulator governing the establishment and implementation of anti-money laundering programs;

(b) Includes, at a minimum~~:~~:

(1) The establishment and implementation of policies, procedures, and internal controls reasonably designed to prevent the financial institution from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of the Bank Secrecy Act and the implementing regulations thereunder;

(2) Independent testing for compliance to be conducted by the futures commission merchant or introducing broker in commodities' personnel or by a qualified outside party;

(3) Designation of an individual or individuals responsible for implementing and monitoring the operations and internal controls of the program;

(4) Ongoing training for appropriate persons;

(5) Appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:

(i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and

(ii) Conducting ongoing monitoring to ~~maintain and update customer information and to~~ identify and report suspicious transactions~~; and~~ and, on a risk basis, to maintain and update customer information. For purposes of this paragraph (b)(5)(ii), customer information shall include information regarding the beneficial owners of legal entity customers (as defined in §1010.230 of this chapter); and

(c) Complies with the rules, regulations, or requirements of its self-regulatory organization governing such programs~~;~~, provided that the rules, regulations, or requirements of the self-regulatory organization governing such programs have been made effective under the Commodity Exchange Act by the appropriate Federal functional regulator in consultation with FinCEN.

Dated: ~~July 23~~May 2, ~~2014~~2016.

Client Update
Final DOL Fiduciary Rules Simplify Some Mechanics, but Retain Core Principles . . . and Flaws

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Last week, the U.S. Department of Labor (the "DOL") finalized its much anticipated regulations expanding the definition of fiduciary investment advice with respect to pension plans covered by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and individual retirement accounts ("IRAs"). Despite extensive comments expressing serious concerns over the potential impact of the 2015 proposal on the ability of broker-dealers, banks, investment advisors and other financial services firms to continue providing advice to retirement investors and the lack of a viable path to preserving commission-based business models common in many aspects of the retirement investor marketplace, the final rules and the new and amended prohibited transaction exemptions have largely the same structure and breadth as the 2015 proposal.

While several significant improvements were made on procedural and technical aspects of the rules and compliance with the available exemptions, the final rules fail to provide any specific guidance or direction regarding how to comply with the demanding conditions of the Best Interest Contract Exemption ("BIC Exemption"). Indeed, despite stating that it provided specific operational advice on how institutions offering proprietary products could comply with the BIC Exemption, the DOL failed to offer any guidance on how such institutions could meet the stringent "best interest" condition of the "Impartial Conduct Standards" of the BIC Exemption (which is discussed in greater detail below). Without that guidance and direction, it is likely that the BIC Exemption, a purported centerpiece of this regulatory initiative, will be unworkable for many of the entities who will require the relief purported to be available thereunder to continue to operate within their existing business models.

Set forth below is our summary of the key changes from the proposal and the aspects of the final rule and revised proposed exemptions that we believe will have the biggest impact on institutions providing services to retirement investors. It does not purport to be a complete summary of the final rule. For an in-depth analysis of the DOL's proposed regulation, including a detailed discussion of the core Impartial Conduct Standards, please refer to our April 21, 2015 client update.

EFFECTIVE DATE

The effective date of the final regulation has been extended to April 10, 2017, nearly a full year after its publication. While this is four months longer than the proposed rule's eight-month implementation period, it is still a very short period of time for entities that have not previously been deemed fiduciaries to make the necessary adjustments to their business practices. The DOL also offered a transition period, running from the April 10, 2017 effective date to January 1, 2018, for complying with a number of the arduous contract, disclosure and other mechanical requirements of the BIC Exemption. However, since the Impartial Conduct Standards will have to be satisfied as of the April 10, 2017 effective date, this transition period will likely not provide any material relief for institutions that will have to significantly restructure their business practices, including the manner in which they compensate their representatives who directly interface with retirement investors.

INVESTMENT ADVICE

The proposed regulation's definition of "investment advice" cast a deliberately wide net, and treated as a fiduciary anyone who makes an investment-related recommendation to an ERISA-covered pension plan, an IRA, a plan participant or IRA owner or beneficiary (a "Retirement Investor") for a fee or other compensation. The final regulation provides substantially the same definition with some key clarifications and changes regarding the limits of the rule's reach.

Seller's Carve-Out

Most significantly, the DOL expanded what was referred to under the proposal as the "seller's carve-out." Under that carve-out, communications made in connection with arm's length transactions with parties that the DOL deemed sophisticated would not give rise to fiduciary status. The seller's carve-out was only available for recommendations made to plans with at least 100 participants or that are represented by an independent fiduciary (including a named fiduciary of the plan) with at least $100 million in employee benefit plan assets under management. The final rule has dropped the 100-participant prong of the carve-out, reduced the assets under management threshold for the independent fiduciary to $50 million and no longer limits the required assets solely to employee benefit plan assets. It also adds a category of relief where the plan is represented by an independent fiduciary that is a bank, broker-dealer, insurance company or registered investment adviser regardless of assets under management. This should provide broad relief to counterparties (such as private equity firms and other sponsors of alternative asset vehicles) that generally deal with large institutional plan investors. Of course, this relief is likely not available with respect to most IRA investors because IRAs are rarely professionally managed by one of the foregoing parties, and the DOL specifically declined to extend the seller's carve-out to situations where an IRA owner otherwise meets certain securities law suitability requirements (e.g., accredited investor or qualified purchaser status), finding that wealth is not an appropriate proxy for financial sophistication.

"Hire Me" Marketing Activities

When dealing with Retirement Investors that are not eligible for the seller's carve-out, the final rule provides far more limited relief with respect to sales pitches and certain types of counterparty communications. In response to commenter concerns that the proposed rule could capture marketing and self-promotion of services to a Retirement Investor, the final rule purports to make clear that only a recommendation of a third party to provide investment advice could give rise to fiduciary duties, and that it is not the DOL's intent to make people fiduciaries for merely engaging in sales pitches to Retirement Investors. However, if an adviser makes specific investment recommendations as part of its pitch, it would not be able to rely on this exception. This is a fine distinction to make and advisors will need to take care to stay on the right side of it in their marketing activities. Additionally, it is not clear to us that an advisor marketing its services through an investment in a specific fund or group of funds would be able to avail itself of this exception, which could create a particular pitfall for fund managers that wish to accept IRA investments.

BEST INTEREST CONTRACT EXEMPTION

The BIC Exemption purports to provide relief for certain common industry compensation practices such as commissions, revenue sharing, sales loads, 12b-1 fees, etc. Under the final rule, absent an exemption such as the BIC Exemption, any individual or entity acting as an investment advice fiduciary to a Retirement Investor would be deemed to have violated the self-dealing prohibitions of ERISA and the provisions of the Internal Revenue Code of 1986, as amended (the "Code") applicable to IRAs upon the receipt of such fees in connection with the recommendation of financial products, because the amount of the fiduciary's compensation would be affected by such recommendations.

Both the proposed BIC Exemption and its final counterpart are conditioned on adherence to an "Impartial Conduct Standard" and specific, detailed disclosure requirements. Like the investment advice definition, the final BIC Exemption provides a number of changes from the 2015 proposal that clarify and simplify certain mechanical aspects to qualifying for the available relief, but ultimately the exemption has largely the same structure, the same requirements and many of the same flaws. The two most significant changes relate to the general applicability of the exemption and the terms of the written contract requirement.

Applicability

The 2015 proposal limited relief to certain types of Retirement Investors. With respect to participant-directed plans, the BIC Exemption was only available for recommendations made to participants or beneficiaries and not to the fiduciaries responsible for establishing the menu of plan investment options. The proposed exemption was also not available for recommendations made to non-participant-directed plans that had 100 or more participants. The final rule eliminates both of these restrictions and dovetails BIC Exemption applicability with the seller's carve-out described above by making relief available to any plan fiduciary that would not be eligible for seller's carve-out relief.

The 2015 proposal was also only applicable to a narrow, plain vanilla list of investments. The DOL eliminated the "approved" list in the final rule, making the BIC Exemption applicable on its face to all forms of investments as long as the other conditions are met. However, in the preamble to the BIC Exemption, the DOL indicated that assets outside the scope of the original approved list would merit special attention and care, and would be subjected to special scrutiny. Thus, it is apparent that the DOL still believes that there are "appropriate" assets for recommendations, and another class of illiquid and riskier investment classes that are generally considered unadvisable for Retirement Investors. It is not clear why this extra attention and care are necessary given that reliance on the BIC Exemption is otherwise predicated on adherence to ERISA's fiduciary duties, including the best interest standard.

Contract Requirement

The DOL has also made substantial changes to the written contract and disclosure requirements. The proposal required a written contract with a Retirement Investor prior to the provision of any investment advice. The final rule has eliminated the contract requirement for ERISA plans (though it still requires written fiduciary status acknowledgement) and provided some guidance and flexibility for IRAs and other non-ERISA plans. Under the final rule, an investment advice fiduciary to an IRA investor can incorporate the contract requirements into the investment advisory agreement, account opening agreement or similar document with the Retirement Investor and the contract can be executed at the time the actual investment is made as long as the required provisions apply retroactively to pre-contract investment advice. The final rule also provides a negative consent mechanism for client relationships already in place on the effective date. Perhaps most significantly, the contract no longer requires a warranty that the fiduciary will comply with all applicable laws and regulations, though other meaningful warranties are still mandatory. However, Retirement Investors expressly continue to have the right to pursue recourse for violations of the BIC Exemption as part of a class action litigation, a feature that the DOL identifies as critical to assuring compliance with the Impartial Conduct Standards.

Impartial Conduct Standards

Despite the technical changes described above and certain other refinements to the BIC Exemption, the final rule has not departed from the core conditions of the proposal: adherence to "Impartial Conduct Standards," adoption of specific policies and procedures to address conflicts of interest and specific and lengthy disclosure to Retirement Investors. As noted above, the final rule also continues to impose a written contract requirement for IRA and non-ERISA plan advice, providing a direct avenue for seeking redress of any purported failure to comply with the contractual undertakings, including through a class action litigation.

The Impartial Conduct Standards have two primary components: a requirement to act in accordance with ERISA's duties of prudence and loyalty and a requirement that compensation received in connection with a recommendation be reasonable within the meaning of Section 408(b)(2) of ERISA and Section 4975(d)(2) of the Code.

The duty of loyalty is expressed in the BIC Exemption as follows:

> [T]he Adviser's recommendation is not based on the financial or other interests of the Adviser or on the Adviser's consideration of any factors or interests other than the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor.

This is significant not just because it effectively imposes ERISA's standard of care, including the duty of loyalty, on certain IRA fiduciaries that are not subject to such duties under the statute, but also for the quagmire that it creates for an investment advice fiduciary that operates on anything other than a level fee (i.e., fixed percentage of assets or flat rate) basis. Historically, the DOL has granted exemptions from the self-dealing prohibitions of ERISA and the Code by first acknowledging that a conflict of interest exists and then conditioning relief on specific procedural safeguards that were designed to assure that the plan or other Retirement Investor was not disadvantaged due to the presence of such conflict. With the BIC Exemption, however, the DOL conditions relief on an Adviser somehow acting without regard to the underlying conflict of interest—and of course being able to prove that its advice was given with an eye solely on the interest of the Retirement Investor when confronted with a class action challenge. Despite pleas from the industry for further guidance on how to meet this condition in light of the stringent requirements imposed under ERISA, the final rule failed to provide any meaningful guidance on how an investment fiduciary could comply with this quandary. Instead, the DOL repeatedly stated that this "duty of loyalty" has been part of the duties imposed on fiduciaries under ERISA since its enactment, and was generally developed from long-standing common law principles. The so-called specific guidance with respect to proprietary products and products that generate third-party fees merely added additional disclosure requirements and mandated documentation, without offering any insight into how to comply with the key requirement of the BIC Exemption.

The DOL also attempted to bring clarity to the reasonable compensation standard by directly incorporating the statutory standard under Section 408(b)(2) of ERISA. The DOL stated that this is "[u]ltimately, a market based standard," but specifically rejected the invitation to embrace "customary" compensation arrangements as satisfying that standard. Unless institutions can refer to customary arrangements to determine market prices and practices, assuring compliance with this portion of the Impartial Conduct Standards will be exceedingly difficult. The DOL suggested that institutions could commission an independent third-party review of their compensation structures, perhaps reflecting its own implicit view that judgments regarding reasonable compensation cannot be made by the person receiving the compensation.

The lack of clear guidance on two of the cornerstone requirements of the BIC Exemption will present significant challenges to institutions that look to rely on this Exemption. Investment advice fiduciaries that receive any compensation that varies based on their recommendations are likely to face significant challenges in proving that they have complied with the Impartial Conduct Standards, and the BIC Exemption will place them in the position of having to do so. The DOL has made clear that the burden of proof will fall to fiduciaries relying on the exemption, and given the exemption's contractual enforcement mechanisms, the litigation risk and expense are likely going to be significant.

NEW AND AMENDED EXEMPTIONS

As part of this rulemaking, the DOL also granted a new exemption for principal transactions in debt securities and amended several existing Prohibited Transaction Exemptions. The key features and changes for each of these are summarized below.

PTE 84-24

Prohibited Transaction Exemption ("PTE") 84-24 historically provided relief from Section 406(a) and 406(b) of ERISA and Section 4975(a)(1)(A)-(F) of the Code for purchases by all Retirement Investors of insurance contracts, annuity contracts and investment company securities. The amendment significantly scales back the scope of this relief by excluding variable rate and indexed annuities, which the DOL has determined must comply with the BIC Exemption to be exempt from the prohibited transaction rules and by limiting the types of compensation that may be received under the exemption. With regard to fixed annuity products, rather than providing an exemption based principally on the plan or other Retirement Investor paying no more than reasonable compensation for the annuity, the exemption will now be conditioned upon satisfying the Impartial Conduct Standards described above (although there is no written contract requirement). The exemption also no longer applies to IRA purchases of mutual fund shares, which must look to the BIC Exemption for relief. These changes represent significant shifts in an established exemption that has been relied upon by the insurance industry and Retirement Investors for over 30 years, and will likely require major internal policy and procedure changes within that industry.

PTE 86-128

PTE 86-128 provides relief for executing securities transactions for a Retirement Investor and receiving a fee or commission in connection with the transaction. Prior to the amendment, it was available for IRA transactions subject only to the condition that the transactions were not excessive (i.e., there was no churning). The amended PTE 86-128 is only available if the IRA fiduciary is a discretionary advisor; investment advice fiduciaries that execute securities transactions will need to comply with the BIC Exemption. The amended PTE imposes the same conditions for IRA transactions as it historically imposed on ERISA plans, requiring specific advance authorization from an independent fiduciary to execute the transactions and periodic disclosures to affected Retirement Investors. It also requires adherence to the same Impartial Conduct Standards as the BIC Exemption and PTE 84-24. Finally, PTE 86-128 has been revised for certain mutual fund transactions that were previously exempt under PTE 75-1

Part II. Like the amendments to PTE 84-24, these are major changes to a well-established exemption that will require affected parties to make substantial changes to certain business practices, policies and procedures.

Principal Transactions in Debt Securities

The DOL granted relief in the proposed rules for a limited set of principal transactions entered into with, and at the recommendation of, an investment advice fiduciary. The proposed exemption was largely the same as the proposed BIC Exemption, and the final exemption's changes tracked the corresponding changes made to the final BIC Exemption.

One notable difference from the BIC Exemption is that the principal transaction exemption's Impartial Conduct Standards require best execution rather than reasonable compensation, and this is deemed satisfied if certain FINRA execution rules are complied with. Additionally, the exemption only applies to purchases of certain specified debt securities, unit investment trusts and certificates of deposit (sales have no such restriction). Eligible debt securities purchased in a principal transaction must "possess no more than moderate credit risk," which the DOL suggested could be read as "investment grade" (though this was done with a wink in the preamble because the Dodd-Frank Act prohibits references to credit ratings in an exemption). The security must also be "sufficiently liquid" so that it may be sold at or near "carrying value within a reasonably short period of time." These credit risk and liquidity conditions mirror language used in a rule promulgated by the U.S. Securities Exchange Commission, which is helpful, but the best interest requirements of the Impartial Conduct Standards pose the same problems with this exemption as discussed above in the context of the BIC Exemption.

Other PTEs

Parts of PTE 75-1, providing relief for a number of common brokerage practices, PTE 77-4, providing relief for investments in affiliated mutual funds, PTE 80-83, providing relief for the purchase of security where the proceeds are used to relieve the debt owed to a party in interest and PTE 83-1, providing relief for the sale of certain mortgage pool certificates, were all amended to impose the Impartial Conduct Standards where the transaction involves potential self-dealing on the part of the fiduciary. The changes to these exemptions will primarily affect IRA fiduciaries by imposing ERISA's fiduciary duties on them with respect to the otherwise prohibited conflicted transactions. While not as seismic as the new BIC Exemption or the changes to PTE 84-24 or 86-128, these amendments are nonetheless significant for the higher standard of care imposed by them.

Recordkeeping requirements for several PTEs, which were previously the responsibility of the plan or IRA involved in the transaction, has been shifted to the plan's counterparty/fiduciary. Additionally, parts of PTE 75-1 have been revoked. Parts I(b) and (c), which provided an exemption for certain agency transactions and non-fiduciary advice were deemed redundant in light of Section 408(b)(2) of ERISA. Part II(2), which provided an exemption for certain mutual fund share purchases, has been moved to PTE 86-128 with respect to ERISA plans, as noted above, and to the BIC Exemption with respect to IRAs (and therefore only applies to investment advice fiduciaries). Those that currently rely on these exemptions will need to review existing agreements and procedures to ensure that they are in compliance with this new regulatory framework.

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Please do not hesitate to contact us with any questions.

Client Update
FINRA Releases Report on Digital Investment Advice Tools

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As technology becomes the predominant means for delivering financial services, industry regulators have focused more keenly on the development, implementation and monitoring of technology-driven "tools" that have been developed to deliver such services. Last week, the Financial Industry Regulatory Authority ("FINRA") turned its attention to so-called robo-advisory services as utilized by broker-dealers.

On March 15, 2016, FINRA released a report (the "Report") discussing digital investment advice tools, which it defined as technologies developed or acquired by financial services firms in connection with developing customer profiles and providing investment advice.[1] Certain of these tools are used by industry professionals in providing financial services to clients while others are accessed by clients on a self-directed basis. The Report gives useful insight into how FINRA views such tools under existing concepts of suitability and conflicts of interests as well as governance and supervision. It also provides lists of principles and effective practices with respect to the various aspects it discusses.

Broker-dealers can expect the matters covered in the Report to begin appearing regularly on FINRA examinations, so we recommend careful consideration of its concepts and findings as a guide for firms utilizing such tools.

I. GOVERNANCE AND SUPERVISION

The Report states that firms should establish adequate governance and supervisory procedures with respect to (a) selection or development of tools to ensure a full understanding of their features and functionality, (b) how

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1 The text of the Report is *available at* http://www.finra.org/sites/default/files/digital-investment-advice-report.pdf.

registered representatives and/or customers will utilize the tools and (c) implementation and ongoing monitoring of the tools and their usage.

According to the Report, many digital advisory tools employ algorithms that translate data inputs into suggested trading strategies or investment advice, such as asset allocation portfolios or the timing of tax-loss harvesting. The Report recommends, among other things, that firms carefully review and test all aspects of the tool, including the financial models and assumptions underlying these algorithms, to fully understand how it will function in a variety of usage scenarios. This testing should be designed to discover any biases or preferences embedded in the algorithms. For example, if a digital tool purports to, among other things, measure the impact of macroeconomic shocks on investor portfolios, the broker-dealer should determine what assumptions are made about the effect of particular shocks on the correlations in asset price movements. Through these insights, the broker-dealer should assess the circumstances in which the tool may provide inappropriate results for some or all customers and take steps to mitigate such situations.

The Report encourages firms to frequently assess and tailor the analytical assumptions used in their chosen digital tools to ensure that they reflect each client’s investment strategies (e.g., passive vs. active portfolio management). It is also prudent for firms to adequately supervise the registered representatives using these tools and review the relationship between a tool’s output, the client’s objectives, and the ultimate recommendations given by such representatives to customers. These concepts align with the Report's discussion of the suitability issues associated with utilizing such tools, addressed next.

In sum, this portion of the Report stresses the importance of a thorough understanding of any investment tools that a broker-dealer decides to deploy so that they can be properly integrated into the firm's business and addressed in the firm's compliance and supervisory structures.

II. CUSTOMER PORTFOLIOS AND SUITABLITY

The Report discusses the use of digital tools in connection with the construction and rebalancing of portfolios, and particularly the associated suitability and conflict of interest issues. These concepts are well-established in FINRA rules and interpretations, and the Report applies them to the digital context in a very traditional manner, essentially saying: even when using technology, make sure you have appropriate information about the customer to recommend or realign a portfolio suitable to his/her needs and disclose any conflicts of interests that may be present.

FINRA Rules 2090 and 2111, and related interpretations, mandate that broker-dealers use a reasonable level of diligence to know the essential facts about a customer at account opening and thereafter in making investment recommendations. Rule 2111 includes a nonexclusive list of information that broker-dealers and their registered persons should consider when assessing the suitability of a recommended security or investment strategy: “the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose.” By implication, the registered person also must have sufficient knowledge of the recommended securities to seek to ensure that they match the customer’s needs.

The Report stresses that broker-dealers and their registered persons are still subject to these new account and suitability requirements even when using a digital advisory tool. The Report states that digital tools are not a substitute for knowledge about the client or the portfolio. Nevertheless, the information required by the rules can be appropriately harvested by the software tool in order to meet these requirements. Indeed, the Report acknowledges that digital advice tools can be used to create a customer profile with the aim of finding an appropriate portfolio of securities based on their responses. The Report provides examples of profiling questions identified by FINRA, which appear designed to address the suitability factors in Rule 2111. The Report also discusses in some detail issues around how a tool handles contradictory or incomplete answers to suitability questions and determinations of customer risk tolerance.

It is therefore important for a broker-dealer evaluating advisory tools to ensure that the tool they choose includes the data points necessary to accurately profile customers and make recommendations. With respect to portfolio and allocation models, the Report recommends that firms have an independent investment policy committee or equivalent responsible for (i) determining the characteristics, such as return, diversification, liquidity and credit risk, of pre-packaged portfolios, (ii) evaluating the individual securities proposed to be included in each portfolio by a digital investment advice tool and (iii) monitoring each portfolio to ensure its performance and risk characteristics are appropriate for its investors. Firms should also consider whether a client’s investment advisory needs can be met solely through a digital approach or may need to include discussions with a financial professional as well.

All of these concepts apply with equal strength in the context of portfolio rebalancing. Rebalancing can occur for a variety of reasons, such as drift from the target allocation due to performance or new market conditions and changes in the customer’s circumstances or goals. Firms may rely on digital advice tools to automatically rebalance portfolios, but should ensure that they understand and agree with the rebalancing methodologies, and that they make appropriate disclosures to customers about the service, including possibly obtaining affirmative customer consent. Among other things, the broker-dealer should disclose the triggers for a rebalancing (like assets diverging from their target allocations in excess of "drift thresholds") or if rebalancing occurs on some periodic basis. Firms should also develop safeguards on the rebalancing process to guard against poorly timed changes and/or tax effects.

In addition to the suitability requirements, the Report reminds firms that FINRA's conflict of interest principles apply with equal force to digital advice tools. Therefore, when constructing a recommended portfolio, broker-dealers should be aware of the potential of conflicts of interests embedded, consciously or unconsciously, in the digital advice tool. Financial incentives can result in the most obvious conflicts of interests, for example, if the tool would result in higher fees to the firm for investments in particular products or for directing business to affiliates.

Disclosure is an important means of countering conflicts of interest. The Report also notes that firms might mitigate any conflicts by adhering to the principles articulated in FINRA Rule 2214, such as disclosing any securities favored by the digital advice tool, explaining the reasoning behind such selectivity, and stating (if applicable) that other investments not considered may have similar or superior attributes to those securities being highlighted by the tool.[2]

III. TRAINING AND LESSONS FOR INVESTORS

The Report encourages firms to train their registered persons on the features and functionality of the tool, proper usage of the tool and human intervention, and the types of customers and situations best suited for using the tool. Training also should occur when changes to the tool are made so that personnel have the most updated information.

The Report also provides "Lessons for Investors" that address issues that customers should consider in connection with using a digital advice tool offered by their broker. The "Lessons" follow the themes articulated above around suitability, rebalancing of portfolios and conflicts of interests. For example, the Report recommends that investors consider whether their financial services firm

[2] Rule 2214 provides for certain requirements with respect to investment analysis tools, primarily in the context of communications with the public and the exception from the general prohibition against using projections or predictions of investment results contained in Rule 2210(d)(1)(F).

is asking the questions necessary to gain a good understanding of their particular circumstances, including investment objectives and risk tolerance.

The Report also urges customers to make sure they understand any potential for conflicts of interests arising out of the tool and its functionality or recommendations that may impair the objectivity of the advice. Firms should be prepared to respond to these questions from their customers.

IV. CONCLUSION

By issuing the Report, FINRA has notified the industry that digital investment advice tools must fit within the existing broker-dealer regulatory framework. The use of such tools is not a substitute for the well-established requirements on broker-dealers and registered representatives when offering investment advice. Firms should be prepared to demonstrate to regulators, including FINRA, that they have reviewed their policies and procedures in light of the Report's recommendations.

* * *

Please do not hesitate to contact us with any questions.

Client Update

Questions Stemming from FINRA's Best Execution Guidance

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On November 20, 2015, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 15-46 entitled "Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets" (the "Notice").[1] Broker-dealers and investment advisers must consider best execution with respect to their trading activities in all types of securities.[2] Both FINRA and the Securities and Exchange Commission ("SEC") have recognized that best execution determinations are not solely about price. Rather, execution quality reviews must consider all facts and circumstances. Accordingly, both regulators have typically guided market participants to focus not on an order-by-order analysis, but to conduct a "regular and rigorous review" execution quality that involves a statistical analysis of routing decisions and trading results during a relevant time period.

The Notice starts out by reiterating this and other longstanding notions about best execution, before breaking new ground on two issues. First, it introduces the concept of applying an order-by-order analysis of execution quality in certain situations, including for large-sized orders and for trades executed internally by a broker-dealer. Second, it discusses best execution for fixed income trades in more detail than previous statements from either FINRA or the SEC, with a focus on electronic trading platforms for these securities. FINRA's stated rationale underlying its new pronouncements is the rise of electronic trading.

Below, we summarize the Notice with a focus on these two aspects and then pose several key questions that remain unanswered but will be important for

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1 *Available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

2 Kirsch, Broker-Dealer Regulation (PLI 2d Ed. 2015) at ch. 19 (by MacHarg, Schneider et al.).

broker-dealers to consider in this context. We expect that best execution committees will consider new policies in light of the new guidance.

DISCUSSION

The Notice first discusses best execution with respect to equities and listed options and then considers it for fixed income securities. FINRA acknowledges the differences between both the rule sets and the historically developed methods of trading in these different marketplaces. It also briefly talks about the potential impact of payment for order flow on best execution, an issue that has received substantial attention.[3] There is also a short discussion of directed orders and the lesser standard of review that applies when a broker-dealer follows the more detailed customer instructions present in these situations.[4]

Equities and Options Best Execution. Perhaps the key sentence in the discussion of best execution for equities and options reads as follows: "FINRA believes that, given developments in order routing technology, order-by-order review of execution quality is increasingly possible for a range of orders in all equity securities and standardized options." The sentence lays out the technological premise that flows through the rest of the analysis, and uses it to justify a requirement that broker-dealers move away from the regular and rigorous review to an order-by-order best execution analysis. FINRA, however, does not provide authority for this principle or an explanation as to what an order-by-order review would entail or how best execution might be demonstrated using such an analysis. For example, the Notice does not specify the factors that one might use for determining whether best execution was satisfied with respect to a particular order, or what comparison would be appropriate in conducting such a review. And with no citation, there is no source material from which a broker-dealer best execution committee might glean an understanding of this order-by-order principle.

FINRA identifies two principal situations in which order-by-order analysis might be, in its view, required: large-sized (block) orders and internally executed

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3 *E.g.*, Permanent Subcommittee on Investigations, *Subcommittee on Investigations to Examine Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets* (June 16, 2014), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-on-investigations-to-examine-conflicts-of-interest-investor-loss-of-confidence-and-high-speed-trading-in-us-stock-markets.

4 The discussion does not address whether an order entered using an algorithm constitutes a directed order and there is no discussion of the distinct requirements that apply to "held" versus "not held" orders.

orders. With respect to block orders, the Notice states that "regular and rigorous review alone (as opposed to an order-by-order review) may not satisfy best execution requirements, given that the execution of larger-size orders 'often requires more judgment in terms of market timing and capital commitment'" (footnote omitted). No interpretive gloss is provided with respect to this statement, and the reader is left to wonder what an order-by-order review would entail for a block trade.

The Notice next discusses internalization, which, it acknowledges, was seemingly addressed in Supplementary Material .09 to FINRA Rule 5130, which concerns best execution. In the Notice, FINRA reads that interpretation to mean only that the *decision* about routing out versus routing internally is subject to the regular and rigorous review standard. That is not, apparently, the case with respect to the internally routed orders themselves: "Orders that a firm determines to execute internally are subject to an order-by-order best execution analysis." There is no clarification concerning what is special about internally routed, as opposed to externally routed, orders or what an order-by-order analysis would entail.

Instead of providing a discussion of what FINRA expects in an analysis of individual orders in any context, the Notice proceeds to remind its readers of the usual best execution requirements concerning (i) regular and rigorous review, (ii) adoption of policies and procedures and (iii) the factors potentially relevant in a standard best execution analysis. It is left for each broker-dealer best execution committee to interpret this new order-by-order principle and how to adapt. The Notice further admonishes broker-dealers who route all of their orders to executing brokers to obtain the execution data and analytics used by their executing brokers as the means for conducting best execution reviews.

Fixed Income Best Execution. The Notice then tackles fixed income trading. The discussion here outlines the different styles of fixed income electronic trading platforms, including those that offer executions and those that function using a request for quote (RFQ) or similar method. "As the availability of electronic systems . . . increases, firms need to determine whether these systems may provide benefits to their customer order flow, particularly retail order flow, and help ensure they are meeting their obligations under the rule with respect to ascertaining the best market for their customer transactions." The remainder of this section of the Notice nicely lays out the facts and circumstances in the fixed income markets that can make best execution evaluations more challenging than in equity and options markets. FINRA's acknowledgement of these difficulties, and discussion of their roots, adds useful information to the issues facing broker-dealers assessing execution quality for fixed income trading.

In the discussion of fixed income markets, FINRA notes both Supplementary Material .03 and Supplementary Material .06 to Rule 5130. The former, in addressing fixed income securities, notes that accessibility of quotations is one of a nonexhaustive list of factors in assessing best execution and that broker-dealers are not relieved of responsibility simply because a quote is not accessible. The latter deals with all security types and requires firms to have policies and procedures for handling situations where there is limited quote and pricing information for a security. While recognizing the wider variety of liquidity profiles in fixed income markets, FINRA nevertheless reminds firms that the best execution duty persists.

In addressing the proliferation of electronic platforms for fixed income trading, the Notice states: "The duty of best execution does not necessarily require a firm to access every available platform that trades fixed income securities, especially given the differences in pricing information and execution functionality offered by different systems." FINRA ends the notice with three examples of situations involving an executing broker using or seeking to use such platforms to obtain quote or pricing information and executing customer orders. The examples are designed to illuminate FINRA's thinking about how a broker-dealer may assess such platforms in order to determine which platforms to access and whether it should join additional platforms in order to source liquidity.

Questions for Best Execution Committees. In light of the principles articulated in the Notice, we believe broker-dealer best execution committees might ask the following questions, among others, as they seek to implement the new guidance and principles articulated in the Notice:

- What does order-by-order best execution analysis mean? That is, do we need to determine for each trade whether a better price was available? And if so, how would we conduct such an analysis?
- For large-sized orders, does the analysis differ depending on whether the order was routed or executed in block size or as a series of child orders?
- Does internalization of orders include agency crosses, or only principal trades made by the broker-dealer?
- If a broker-dealer operates a fixed income trading platform, under what circumstances must it consider routing orders to another liquidity provider or platform?
- What factors will fixed income traders use to determine the fungibility of different securities when seeking to use those similar securities as a basis for evaluating pricing?

- How often, and on what basis, will a best execution committee evaluate fixed income platforms that the firm does not utilize to determine whether to start accessing other platforms and/or replace existing platforms with new platforms?

CONCLUSION

FINRA's new guidance in the Notice provokes significant questions as it seeks to provide direction on best execution. Broker-dealers have long asked their best execution committees to tease out the complexity associated with this important facet of the business. With FINRA's new considerations in mind, the next several committee meetings should prove interesting.

* * *

Please do not hesitate to contact us with any questions.

BUSINESS LAW TODAY

The SEC Hands Out a Halloween Treat to Crowdfunding Supporters

Peter J. Loughran, Lee A. Schneider, Ebunoluwa A. Taiwo, Gabriel W. Lezra

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On October 30, 2015, the Securities and Exchange Commission (SEC) adopted Regulation Crowdfunding (the "Final Rule"), which regulates the offer and sale of securities through a new type of offering involving a general solicitation without SEC registration. Regulation Crowdfunding *codified as amended at* 17 C.F.R § 200, 227, 232, 240, and 249 (2015). Conceptually, crowdfunding as envisioned by Title III of the Jumpstart Our Business Startups Act (the JOBS Act 15 U.S.C. § 77a *et seq*.) is simple. It allows an issuer to raise capital, either equity or debt, in a small offering open to all investors, but limits the total amount purchased by any investor. Title III and Regulation Crowdfunding seek to model popular websites like Kickstarter and IndieGoGo, for securities offerings, but with various "guardrails" designed to prevent fraud and protect investors. The Final Rule sets forth the regulatory apparatus for these offerings

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BUSINESS LAW SECTION

THE LAST LAUGH

"I know that file's here somewhere."

BLS TRIVIA QUESTION

Question: On April 13, 2010, Maryland became the first state to recognize benefit corporations (or B-corps, as they are colloquially known) with the adoption of the Maryland Benefit Corporation Act (Maryland Corporations and Associations Article that will govern both the issuers and the intermediaries (the so-called “funding portals,” subject to oversight by both the SEC and the Financial Industry Regulatory Authority (FINRA)) as part of the JOBS Act.

We expect crowdfunding to appeal, at least initially, to two broad groups of issuers: smaller companies doing an early stage fund-raising and issuers seeking to enhance their relationships with customers. This second group might use crowdfunding as more of a promotional tool to create interest in its products or services and to allow customers the ability to invest in something that really excites their imagination. These “first mover” customers can be quite effective in generating buzz for a product or idea. The tie-in with an ownership stake could be a powerful means to develop initial customer loyalty and enthusiasm.

Below we summarize the key provisions of Regulation Crowdfunding.

Effective Date

Regulation Crowdfunding will become effective May 16, 2016. The forms that will enable funding portals to register with the SEC will become effective January 29, 2016.

Investors

Offerings under Regulation Crowdfunding are not registered offerings, but there are no limitations on who may invest. While the SEC has already permitted crowdfunding-type offerings to accredited investors in the AngelList and Funders Club no-action letters, offerings under JOBS Act Title III and Regulation Crowdfunding are not exclusively for accredited investors.

Issuers

Many, though not all, U.S. companies will be eligible to conduct a crowdfunding offering. Companies that are ineligible include non-U.S. companies, issuers that are already SEC reporting companies, and both registered and exempt investment companies. Additionally, certain issuers would be ineligible, including (a) companies disqualified under Section 302(d) of the JOBS Act and Final Rule Section 503 (which includes, among other things, certain designated “bad actor” disqualifications), (b) previous crowdfunding issuers that have failed to comply with the applicable annual reporting requirements during the two years prior to a new offering, (c) companies that have no specific business plan, and (d) companies whose sole business plan is to engage in a merger or acquisition with one or more other companies. Bad actor disqualification will occur based on a list of triggering events, including, but not limited to, certain criminal or civil securities law violations within the preceding five years.

Limitations on Amounts Raised Through Crowdfunding

§§ 5-6C-01 through -08). The Maryland Benefit Corporation Act was sponsored by a member of the American Bar Association. Can you name him?

Please see Inside Business Law for the answer to this month’s Business Law Section Trivia Question.

IN THE NEXT ISSUE

The August issue of *BLT* will focus on an important issue in business law practice: diversity. Other feature articles focus on an array of topics: the Yates Memo, protecting your brand in a complicated Internet landscape, and immigration law compliance. This *BLT* issue contains much more business law content—don’t miss it!

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SECTION NEWS

DHS Proposes Collecting Social Media Account Information

Regulation Crowdfunding sets the maximum that can be raised at $1 million. The Final Rule made no changes to this limit despite significant comments on the issue. In discussing this decision, the SEC made clear that it had considered and rejected commenters attempts to exempt the costs associated with the fund-raising (e.g., funding portal fees and attorneys' fees) from the limits. Only capital raised in reliance on Regulation Crowdfunding will count toward this $1 million annual limit and there is no integration of these offerings with other offering types.

Limitations on Amounts Individuals May Invest and Secondary Transactions

During the trailing 12 months preceding any crowdfunded transaction, an investor may invest no more than: (i) the greater of: $2,000 or 5 percent of *the lesser of* the investor's annual income or net worth if *either* annual income or net worth is less than $100,000; or (ii) 10 percent of *the lesser of* the investor's annual income or net worth, not to exceed an amount sold of $100,000, if *both* annual income and net worth are $100,000 or more. The investment limit reflects the aggregate amount an investor may invest across all crowdfunding offerings and all issuers in a 12-month period. These limitations apply to all investors, including retail investors (whether or not accredited) and institutional investors, and both U.S. and non-U.S. citizens or residents.

Regulation Crowdfunding Rule 501 prohibits the transfer of securities issued in the crowdfunding for a period of one year, other than to the issuer, an accredited investor or a family member of the purchaser. This transfer restriction also is binding on any purchaser within the first year, such that any purchaser in the primary issuance or secondary market during the first year can only sell to those permitted purchasers.

Restrictions on Intermediaries

Section 4A permits two types of intermediaries for a crowdfunding offering: a registered broker-dealer and a new type of regulated entity called a "funding portal." The issuer may use only one intermediary in connection with its offering. Funding portals must register with both the SEC and a self-regulatory organization (SRO). FINRA has adopted final rules for the registration of funding portals. Notice of Filing a Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4528 (Oct. 22, 2015) . While the overall regulatory burden on funding portals will be somewhat less than what broker-dealers face, as a regulated entity the funding portal will nevertheless need to consider and establish compliance functions commensurate with the level and complexity of their organizations and can expect FINRA (and the SEC) to exercise regulatory oversight over their activities.

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Content Corner: June Digest
Trademark Claim Fallout: Indie Devs Take on the Corporate Goliath
All News

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August 9-10, 2016
Saratoga Springs, NY

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September 8-10, 2016
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OTHER NEWSLETTERS

Miscellaneous IT Related Legal News (MIRLN) 26 June - 23 July 2016 (v19.10)

ABOUT BUSINESS LAW TODAY

BLT is a web-based publication drawing upon the best of the Section's resources, including featured articles and other information from around the Section. Stay informed on the latest business law practice

Cybersecurity has been a recent area of focus from both the SEC and FINRA for broker-dealers (and investment advisers). Feigelson, Schneider, Shaul, "SEC Regulation of Cybersecurity and Tech Risk Converges," LAW360 (Oct. 23, 2015). It will be interesting to see how funding portals and their regulators approach this issue.

Disclosure Requirements

An issuer wishing to avail itself of Regulation Crowdfunding must file specified disclosures with the SEC and provide these disclosures to investors and the relevant intermediary for dissemination to investors by posting on its platform. These disclosures would include, for example, certain disclosures related to the issuer and the issuer's business, the offering itself, and certain investor-protection statements.

In addition to disclosures during the offering, issuers of successful crowdfunding offerings will be required to file an annual report with the SEC and provide it to investors. These annual reports require disclosures of information similar to what is contained in the offering disclosures, but much less than is required of a public company. The SEC expects the issuer to determine how best to convey the information.

Intermediary Obligations

Whether the intermediary is a broker-dealer or a funding portal, its obligations in connection with each offering follow the same basic pattern: (1) they are required to maintain a web platform to host the offering and provide certain consumer protection disclosures; (2) they must open accounts for investors in the offering; and (3) they must arrange for the secure transmission of funds and securities.

Advertising the Offering

An issuer generally may not advertise the terms of the offering, except though the intermediary's platform. However, issuers may utilize a notice containing the terms of the offering, basic factual information about the issuer and the Internet address of the intermediary's platform. There are no limitations on how the issuer can make this notice available. If the issuer's chosen intermediary is a funding portal, the funding portal also may not advertise the offering, but can advertise its services as an intermediary in crowdfunding transactions generally and identify one or more issuers or offerings available on its platform.

The issuer and its employees may participate in any discussion forum or other similar communication channel on the platform so long as it identifies itself as an issuer. Intermediaries are required to have such a communications mechanism on their platforms and make it available in all offerings. Additionally, the issuer can utilize (and compensate) promoters to participate through the communications channel, so long as the promoter identifies itself as such each time it makes a "promotional communication" and discloses that it has earned or will earn compensation for its efforts. Note, however, that the SEC understands "promoters" to broadly apply to all persons "acting on behalf of the issuer," regardless of whether the compensation they will receive is specifically tied to promotional activities.

Restrictions on Compensation in Connection with an Offering

The Rule places various limitations on the payment and receipt of compensation in connection with a crowdfunding offering. The restrictions can depend on the identity of the payer, the recipient, or both. Issuers may compensate the intermediary for its participation in the offering, which can include an ownership interest, so long as the ownership interest is of the same type as that being offered on the intermediary's platform. Funding portals may compensate others for the referral (but not solicitation) of issuers and investors so long as the compensation is not transaction-based, unless the person it will pay is a registered broker-dealer; however, they may not compensate anyone for soliciting investors or prospects and may not pay transaction-based compensation to anyone (lest they be required to register as a broker-dealer).

Conclusion

Regulation Crowdfunding adds a new, more innovative twist to the capital markets. The SEC has sought to balance the promise of such innovation with its traditional investor protection role. How these offerings evolve and whom they target will keep industry watchers busy in the years to come. We cannot wait to look at the first offering.

Additional Resources

For other materials on this topic, please refer to the following.

ABA Web Store

The Final Frontier: Regulation A+ and Crowdfunding

Business Law Section Program Library

The Final Frontier: Regulation A+ and Crowdfunding (PDF) (Audio)
Presented by: State and Regulation of Securities Committee
Location: 2015 Spring Meeting

New Opportunities for Unregistered Securities Offerings – Today and Tomorrow (PDF) (Audio)
Presented by: Federal Regulation of Securities Committee, Middle Market and Small Business

Committee, State Regulation of Securities Committee
Location: 2015 Annual Meeting

Emerging Investment Platforms – Peer to Peer, Crowdfunding, and Affinity Investing (PDF) (Audio)
Presented by: Business Financing Committee, Federal Regulation of Securities Committee
Location: 2014 Annual Meeting

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SEC Regulation Of Cybersecurity And Tech Risk Converges

Law360, New York (October 23, 2015, 4:14 PM ET) -- In the last several years, cyberattacks affecting high-profile companies have received much publicity. Technology-related disruptions in the securities markets also have received significant publicity and resulted in enforcement actions. In combination, these events have put cybersecurity and technology risk at the forefront of the agenda of the U.S. Securities and Exchange Commission.


Jeremy Feigelson


Lee A. Schneider


Max Shaul

First, the SEC used its regulatory power to promulgate Regulation Systems Compliance and Integrity ("Reg SCI"), proposed in spring 2013 and adopted in fall 2014, with an implementation date of Nov. 5, 2015.[1] Reg SCI sets a series of standards for SCI entities (exchanges and large alternative trading systems, among others) with respect to their development, implementation and monitoring of SCI systems (defined to include systems relating to the execution, clearing and settlement of trades), including notification protocols and a safe harbor from liability for individuals. "Systems intrusions" (Reg SCI-speak for cybersecurity breaches) are one of the main contingencies for which SCI entities must take these steps, implement corrective actions and provide notification to the SEC and affected market participants.

Second, starting in April 2014, the SEC's Office of Compliance Inspections and Examinations (the “OCIE”) issued the first of three risk alerts focused on cybersecurity.[2] This first risk alert announced examination priorities for an upcoming review of cybersecurity preparedness at broker-dealers and investment advisers. The OCIE conducted this first slate of examinations and released its findings in a second risk alert on Feb. 3, 2015.[3] Then, on Sept. 15, 2015, the OCIE issued a third risk alert identifying a new set of cybersecurity priorities applicable during its 2016 exams and giving financial services firms guidance as to the OCIE's expectations of how they should be addressing cybersecurity.[4]

The risk alerts in conjunction with Reg SCI provide insight into the SEC’s current position on what constitutes adequate cybersecurity preparedness for broker-dealers and investment advisers. While clear written policies and procedures are a key component, firms are well-advised to have strong internal structures to ensure effective implementation and ongoing assessment of both the policies and the systems themselves. And as a recent enforcement action indicates, simply reporting a cyberbreach to the SEC and taking mitigating steps to protect clients after the fact may not be sufficient in the current climate, especially where customer privacy might be implicated.

Below we summarize in more detail Reg SCI and the risk alerts and then briefly discuss key provisions of Reg SCI — not discussed in the risk alerts — that may provide insight into the SEC's cutting-edge thinking about cybersecurity. We also look for insights from the SEC’s recent settlement with a registered investment adviser regarding a cybersecurity breach. With the popular focus on all things "cyber," the financial services industry would do well to pay close attention.

Reg SCI

The SEC adopted Reg SCI in response to a number of significant technology issues experienced by various market participants.[5] Although no cybersecurity incident appears to have been among the catalysts, the SEC included protocols around "systems intrusions" as part of the requirements under Reg SCI in recognition of the importance that systems security can play in technological disruptions. As such, all of Reg SCI's requirements, as summarized below, apply to all aspects of a firm's technology, including cybersecurity.

Simply put, Reg SCI attempts to regulate the development, implementation and ongoing monitoring of technology infrastructure at so-called “SCI entities.” This designation includes most self-regulatory organizations (e.g., exchanges, FINRA and MSRB), alternative trading systems with volume above certain minimums, and a few other significant market utilities such as clearing agencies. It is important to note that Reg SCI as of now does not apply broadly to the broker-dealers and investment advisers examined by the OCIE. SEC Chair Mary Jo White and other SEC officials have stated that the SEC is looking into whether to extend the regulation to “other market participants” including broker-dealers.[6]

The rule defines SCI systems as “all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance.”[7] Reg SCI outlines two categories of SCI systems: critical SCI systems and indirect SCI systems. Critical SCI systems are defined as any systems that “directly support functionality relating to: (1) Clearance and settlement systems of clearing agencies; (2) Openings, reopenings and closings on the primary listing markets; (3) Trading halts; (4) Initial public offerings; (5) The provision of consolidated market data; or (6) Exclusively-listed securities ...”[8] This category also applies to those systems that “provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets.”[9] Indirect SCI systems are defined broadly as “any systems of, or operated by or on behalf of, an SCI entity that, if breached, would be reasonably likely to pose a security threat to SCI systems.”[10]

Reg SCI mandates that SCI entities institute policies and procedures designed to ensure that SCI systems “have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity’s operation capability and promote the maintenance of fair and orderly markets.”[11] These policies should include periodic testing and updating of cybersecurity procedures and the establishment of business continuity and disaster recovery plans in the event of breaches. The business continuity plan must be “reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption.”[12]

SCI entities also need to put into place procedures to identify responsible SCI personnel.[13] The regulation provides a safe harbor from liability for any such SCI personnel who have “reasonably discharged” their duties or who were "without reasonable cause to believe” the system was not in compliance with the firm's policies, the system's intended functionality or applicable Reg SCI requirements. No safe harbor applies to SCI entities.[14]

Reg SCI also regulates how SCI entities must respond to an “SCI event,” which is defined in three categories. The first is a “systems disruption,” which includes any event “that disrupts, or significantly degrades, the normal operation of an SCI system.”[15] The second, “systems compliance issues,” is defined as “an event ... that has caused any SCI system ... to operate in a manner that does not comply with the [Securities Exchange] Act [of 1934] and the rules and regulations thereunder or the entity’s rules or governing documents, as applicable.”[16] The third category is a “systems intrusion,” defined as “any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity” and thus includes, among other things, cybersecurity breaches, introduction of malware and any breach related to employee misconduct or negligence.[17]

Upon the occurrence of an SCI event, the SCI entity must take “appropriate corrective action to mitigate potential harm to investors and market integrity” and “devote adequate resources to remedy the SCI event as soon as reasonably practicable."[18] Appropriate action includes providing written notification to the SEC within 24 hours of the event as well as periodic status updates on the investigation into, and resolution of, the event. The SCI entity must also send the SEC a report discussing who the event affected and to what extent. Relatedly, Rule 1002(c) of Reg SCI requires an SCI entity to disseminate information regarding major events to all of its members or participants, and about certain lesser SCI events to affected members or participants.[19] The reporting standards are much less burdensome for events defined as "de minimus."[20]

The February Risk Alert

The February risk alert reported on the findings of examinations the OCIE staff conducted of 57 registered broker-dealers and 49 registered investment advisers, intended to "evaluate how these entities handled the legal, compliance and regulatory issues related to cybersecurity."[21] The OCIE did not provide substantive guidance on best practices or expectations for broker-dealers and investment advisers, but simply reported on what the examinations found. As part of the examinations, the OCIE staff obtained information from each firm on how it (i) identified cybersecurity risks, (ii) adopted and implemented policies, procedures and oversight for cybersecurity and (iii) protected their networks and information in the event of a breach or intrusion. The February risk alert gives a statistical breakdown of the practices uncovered by the examinations.

Much of the emphasis of the February risk alert concentrates on written procedures and processes for cybersecurity risk assessment and mitigation. The report found that the majority of examined broker-dealers (93 percent) and investment advisers (83 percent) had in place written information security policies and procedures. Most of the firms periodically performed audits in order to assess compliance with these policies and procedures. Most entities reported performing firmwide inventorying, cataloguing or mapping of their technology systems and resources. Many firms reported that they were using external standards (like those of the National Institute of Standards and Technology, the International Organization for Standardization, and the Federal Financial Institutions Examination Council) as models for their cybersecurity processes and procedures. Most of the examined firms' information security policies and procedures did not address how they would determine whether they were responsible for client losses in cyber-related incidents. In almost every category, a higher percentage of the examined broker-dealers had implemented the types of policies and practices scrutinized by the OCIE staff than was the case for the examined investment advisers.

While a majority of the broker-dealers (nearly 75 percent) had incorporated cybersecurity measures into contracts with their vendors and business partners, the investment advisers were found to be lagging in this area.[22] The February risk alert noted that most of the firms subject to the examination had experienced a cyber-related incident either directly or through one or more of their vendors, and that the majority of the cyber-related incidents were related to malware and fraudulent emails. The OCIE staff reported that a quarter of the losses due to fraudulent emails resulted from employees failing to follow the firm's identity authentication procedures.[23]

September Risk Alert

On Sept. 15, 2015, the OCIE issued the September risk alert announcing that it will conduct a second round of examinations of broker-dealers and investment advisers to assess cybersecurity preparedness. The OCIE identified six areas on which this next round of examinations will focus. The September risk alert discusses each area in some detail and in doing so provides insight into the OCIE's expectations for broker-dealers and investment advisers. It also includes a sample document request list, which suggests the kinds of documentation relating to cybersecurity that the OCIE expects to see at firms.[24]

The first category is "Governance and Risk Assessment." This category includes looking into whether registrants have procedures for risk assessment in place that are appropriate for their business and whether the firm periodically evaluates them. It will also assess the level of communication to, and involvement of, senior management and directors, including information on the firm's chief information security officer and other employees responsible for cybersecurity matters. The OCIE's document requests might seek, for example, policies and procedures related to protection of client records and board minutes, and briefing materials regarding cybersecurity matters.

The second category is labeled "Access Rights and Controls." Examiners may ask how firms control access to various systems and data through management of user credentials, authentication and authorization methods. Remote access, customer logins and password protocols fall within this area. The SEC also focused on this issue in its 2010 Market Access Rule.[25]

The third category, "Data Loss Management," centers on how firms monitor the content that employees and third parties transfer to and receive from outside the firm. Employee and third-party uploads and email attachments are mentioned in this context. The OCIE seems particularly interested in the controls in place for protecting the personally identifiable information of customers, which has implications, among others, under the SEC's Regulation S-P governing privacy of customer information.[26]

The next two areas likely stem in part from concerns raised in the February risk alert. The fourth category is “Vendor Management.” According to the OCIE, some of the largest cybersecurity breaches have come from hacking of third-party vendor platforms that then provide a means of entrance to the real target's systems. The OCIE intends to review how firms choose and monitor their vendors, including requests for documents or notices that firms require from their vendors related to technology systems and cybersecurity measures at the vendor. The fifth category, “Training,” looks at the adequacy of training given by firms to employees and third-party vendors who might form the first line of defense against cybersecurity risks.

The final category is “Incident Response.” Examiners will evaluate whether and how the firm’s business continuity plan handles mitigation and recovery from a cybersecurity breach. They may also ask for information regarding how firms have handled incidents in the past.

The September risk alert sharpens the focus on third-party vendor management and preparedness for cybersecurity incidents through written procedures and their proper implementation. Vendors have been the attack vector in a remarkable number of high-profile breaches. While the first set of examinations attempted to determine whether firms had in place cybersecurity procedures and processes, this second alert seems to assume these policies will be in place and indicates that going forward the focus will be on implementation, training and access controls.

Discussion

Several key themes appear in Reg SCI and the risk alerts. First, all three focus on the firm's written policies and procedures. While not a new concept for either broker-dealers or investment advisers, the adoption of policies and procedures specific to technology moves them into a new realm. Indeed, the September risk alert makes clear that the OCIE now assumes that both broker-dealers and investment advisers have created and implemented policies and procedures with respect to cybersecurity. Consequently, the OCIE will now focus on whether these procedures have been implemented at all levels of the firm and with respect to all systems, including those provided by vendors.

A second theme concerns the level of responsibility (as distinct from liability) for all types of employees, and especially senior management and the board for developing and implementing the procedures, understanding the systems and technologies, and regularly monitoring and testing to ensure compliance and appropriate functioning. It seems beyond doubt that the SEC wants an "all hands on deck" approach to these issues. The third theme revolves around vendor management and requirements to not only understand vendor systems but also to ensure that vendors do not provide entrance into the firm. The SEC recognizes with this approach that the weak link could be a vendor even where the firm itself has robust protocols.

Two requirements in Reg SCI do not seem yet to be a focus specifically of the OCIE cybersecurity initiative. First, Reg SCI includes affirmative reporting obligations, both to the SEC and to other market participants. As a result, SCI entities will need to develop policies and procedures for generating and delivering such reports, and the recipients will need to think about how to use that information and what actions to take upon receipt. SCI entities will also need to carefully consider what should be included in such reports and when dissemination of reports to other market participants is necessary.

Second, Reg SCI contemplates personal liability for individuals at SCI entities in the event of an incident. The undeniable implication of the safe harbor for individuals who reasonably discharge their duties demonstrates the SEC's preparedness to use its regulatory enforcement power to hold SCI personnel responsible for technology problems. The inclusion of the potential for individual liability reflects how seriously the SEC takes the risk-mitigation obligations it has imposed through Reg SCI. Moreover, the safe harbor from liability for those who were “without reasonable cause to believe” the system was not in compliance implies that individuals have a duty of inquiry as to whether systems might be the subject of an intrusion. Consequently, SCI entities and the individuals they employ must remain cognizant of this duty to continue to monitor systems in an effort to detect breaches.

Whether these notification and liability requirements will become standard for cybersecurity events remains to be seen. That cybersecurity liability resonates in the halls of the SEC was shown just one week after publication of the September risk alert with the settled enforcement matter against R.T. Jones Capital Equities Management, a registered investment adviser. Though the breach at R.T. Jones was minor, did not cause significant financial losses for customers, and was identified and reported to the SEC as well as customers, these factors were not the focus of the action. Marshall S.

Sprung, co-chief of the SEC Enforcement Division's Asset Management Unit, articulated the SEC's focus on preventative procedures: "As we see an increasing barrage of cyber attacks on financial firms, it is important to enforce the safeguards rule even in cases like this when there is no apparent financial harm to clients ... Firms must adopt written policies to protect their clients' private information and they need to anticipate potential cybersecurity events and have clear procedures in place rather than waiting to react once a breach occurs."[27] We also hear quite clearly the echoes of the focus on policies and procedures in both the risk alerts and Reg SCI in the findings that R.T. Jones did not include in its procedures and protocols (i) periodic risk assessments, (ii) the use of firewalls, (iii) encryption of client information, or (iv) clear guidelines for responding to a cybersecurity breach.

Conclusion

In a speech at a Managed Funds Association conference on Friday, Chair White noted cybersecurity as a major operational risk for private fund sponsors.[28] On that same day, the director of the SEC Division of Enforcement noted: "If firms don't have appropriate policies and procedures in place, that could be a [regulation S-P] violation."[29] The twin regulatory initiatives represented by the risk alerts and Reg SCI warrant further attention at both broker-dealers and investment advisers.

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[1] Regulation Systems Compliance and Integrity, Securities Act Release No. 34-73639 (Nov. 19, 2014) (hereinafter, the "Reg SCI Release"); *see also* Proposed Rule: Regulations Systems Compliance and Integrity, Securities Act Release No. 34-69077 (Mar. 8, 2013).

[2] *See* OCIE Cybersecurity Initiative (Apr. 15, 2014), *available at* https://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf. The SEC also held a roundtable on cybersecurity in March 2014. In her opening remarks at this roundtable, SEC Chair Mary Jo White asserted that cybersecurity threats are global and present a

great risk to our economy. Chair White went so far as to say that such risks are "first on the Division of Intelligence's list of global threats, even surpassing terrorism." *See* a transcript of the Cybersecurity Roundtable, *available at* https://www.sec.gov/spotlight/cybersecurity-roundtable/cybersecurity-roundtable-transcript.txt.

[3] OCIE Cybersecurity Examination Sweep Summary (Feb. 3, 2015), *available at* https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[4] OCIE's 2015 Cybersecurity Examination Initiative (Sept. 15, 2015), *available at* https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

[5] *See* Reg. SCI Release at 7.

[6] *See* Chair White's "Statement at Open Meeting on Regulation SCI" (Nov. 19, 2014) (stating that Commissioner White directed the SEC staff to prepare recommendations "as to whether an SCI-like framework should be developed for other key market participants, such as broker-dealers and transfer agents"); *see also* Commissioner Stein's Remarks before the Securities Traders Association's 82nd Annual Market Structure Conference (Sept. 30, 2015), *available at* http://www.sec.gov/news/speech/stein-market-structure.html.

[7] Reg SCI Release at 712.

[8] *Id*. at 709.

[9] *Id*.

[10] *Id*. at 710.

[11] *Id*. at 712.

[12] *Id*. at 712, 713.

Id. at 715.

[14] *Id*. at 209.

[15] *Id*. at 712.

[16] *Id*.

[17] *Id.* at 140, 141, 712.

[18] *Id.* at 715.

[19] Reg SCI Release at 667, 718-719.

[20] *Id*. at 717, 718; Reg SCI also imposes affirmative reporting requirements and other obligations on SCI entities regardless of whether there has been a breach. The entities must (1) submit a quarterly report detailing any material changes to SCI systems as well as to the security of indirect systems (*Id*. at 730); (2) conduct yearly "SCI reviews," which should assess "internal control design and effectiveness of its SCI systems and indirect SCI systems to include logical and physical security controls, development processes, and information technology governance" (*Id*. at 711); (3) send to the SEC and the entity's board of directors a report including the SCI review and senior management must respond within 60 days of receiving the report (*Id*. at 720); and (4) to "make, keep, and preserve" certain documents demonstrating compliance, and to provide them to the SEC upon request (*Id*. at 721). Moreover, a penetration test of "network, firewalls and production systems" must happen every three years. *See Id*. at 720.

[21] February Risk Alert at 1.

[22] Cybersecurity preparedness in relation to third parties receives more attention in the September Risk Alert, *see* September Risk Alert at 2, Appendix at 4.

[23] Training and implementation of written procedures are more of a focus in the September Risk Alert, *see* September Risk Alert at 2-3, Appendix.

[24] *See* Debevoise & Plimpton LLP, Client Update: SEC Releases Updated Cybersecurity Examination Guidelines (Sept. 18, 2015), *available at* http://www.debevoise.com/~/media/files/insights/publications/2015/09/20150915a_sec_releases%20updated_cybersecurity_examination_guidelines.pdf.

[25] Risk Management Controls for Brokers or Dealers with Market Access, Securities Act Release No. 34-63241 at 12-22, 126-127 (Nov. 3, 2010), *codified at* 17 C.F.R. § 240.15c3-5; *see also* OCIE National Exam Risk Alert: Master/Sub-accounts (Sept. 29, 2011), *available at* https://www.sec.gov/about/offices/ocie/riskalert-mastersubaccounts.pdf.

[26] Rule 30 of SEC Regulation S-P, known as the "Safeguards Rule", mandates that investment advisers, broker-dealers and investment companies create and maintain reasonably designed written policies and procedures to protect the security and confidentiality of customer records and information. *See* Privacy of Consumer Financial Information (Regulation S-P), Securities Act Release No. 34-42974 (Nov. 18, 2003), *as codified at* 17 C.F.R. § 248.

[27] http://www.sec.gov/news/pressrelease/2015-202.html.

[28] Chair White's "Five Years On: Regulation of Private Fund Advisers after Dodd-Frank" (Oct. 16, 2015) (noting cybersecurity as a major operational risk and saying: "Staff guidance earlier this year encouraged advisers to assess their ability to prevent, detect and respond to attacks in light of their compliance obligations under the federal securities laws, and detailed a number of measures advisers may wish to consider. Pay careful attention to the areas discussed in the guidance." (footnote omitted))

[29] *See* Priya Anand, MarketWatch, *A crackdown is coming on firms with lax cybersecurity* (Oct. 16, 2015), http://www.marketwatch.com/story/a-crackdown-is-coming-on-firms-with-lax-cybersecurity-2015-10-16.

Client Update
FINRA Focuses on Broker-Dealer Liquidity Risk Management

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On September 15, 2015, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 15-33 (the "Notice") entitled "Guidance on Liquidity Risk Management Practices."[1] The Notice stakes out FINRA's position on liquidity risk management as an important function for its member broker-dealers and discusses the areas that FINRA considers relevant when determining whether a firm has implemented appropriate liquidity risk management practices. FINRA developed the contents of the Notice in the course of examining the liquidity practices of 43 firms with the twin goals of understanding existing practices and "raising awareness of the need for liquidity stress planning" at broker-dealers.[2]

The Notice comes at a time when the Basel Committee and U.S. banking regulators are focused intently on liquidity risk through the recently developed liquidity coverage ratio ("LCR") and net stable funding ratio ("NSFR").[3] U.S. banking organizations have started to implement the requirements of the LCR, which was finalized on September 3, 2014, and must be fully implemented by January 1, 2017.[4] The LCR, in broad terms, requires banking organizations, on a

1 FINRA, Notice 15-33, *Guidance on Liquidity Risk Management Practices* (Sept. 3, 2015), *available at* https://www.finra.org/industry/notices/15-33.

2 *Id.* at 2.

3 *See* Lee A. Schneider, Chen Xu & Gregory J. Lyons, *Application of Recent Liquidity Regulations to Banking Organizations and Key Impacts When Implementing Them*, J. TAX'N & REG. FIN. INST. (May/June 2015).

4 *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61440 (Oct. 10, 2014); *see also* Byungkwon Lim, Gregory J. Lyons, Satish M. Kini, Lee A. Schneider, David L. Portilla, Samuel E. Proctor, Amelia Russell & Chen Xu, *Questions and Answers on the Liquidity Coverage Ratio*, HARVARD L. F. CORP. GOVERNANCE & FIN. REG. (Oct. 4, 2014), *available at* http://corpgov.law.harvard.edu/2014/10/04/questions-and-answers-on-the-liquidity-coverage-ratio/.

consolidated basis, to keep one dollar of high quality liquid assets for each dollar of expected net cash outflows over a thirty-day period. The NSFR is designed to complement the LCR by requiring banking organizations to, in effect, have capital and long-term borrowing facilities in place to support their assets. While the regulators have not yet proposed a U.S. version of the NSFR, the Basel Committee finalized the global version on October 31, 2014.[5]

With the Notice, FINRA now seeks to have its member broker-dealers make liquidity management part of their best practices: "[e]ffective liquidity management is a critical control function at broker-dealers and across firms in the financial sector."[6] While bank-affiliated broker-dealers must grapple with these issues as part of a consolidated financial services organization, the Notice plainly states that these firms must also consider liquidity even within their four walls.

DISCUSSION: FINRA EVALUATES LIQUIDITY RISK MANAGEMENT PRACTICES

The Notice is based upon FINRA's review of 43 firms' practices with respect to liquidity risk management and its view of the need for liquidity stress planning to ensure firms properly measure and consider liquidity needs in a stressed environment. FINRA chose a thirty-day stress period as the time frame for effective liquidity risk management.[7] In analyzing each firm's preparedness for such a situation, FINRA assessed: (1) the impact on liquidity of five scenarios that stressed the firm's business and (2) any mitigating actions the firm could take to offset stressed outflows of cash. FINRA noted that it developed the stress scenarios based in part on situations that have led to failures of broker-dealers. The five scenarios involved:

- Loss of funding from inventory positions due to devaluation;
- Stressing of match-book repo and securities lending transactions;

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5 Basel Committee on Banking Supervision, *Basel III: The Net Stable Funding Ratio* (Oct. 31, 2014), *available at* http://www.bis.org/bcbs/publ/d295.htm; *see also* Gregory J. Lyons, Satish M. Kini, Lee A. Schneider, David L. Portilla, Melissa A. Mitgang, Samuel E. Proctor & Chen Xu, *Basel Committee Adopts Net Stable Funding Ratio: How Much Liquidity is Enough?*, HARVARD L. F. CORP. GOVERNANCE & FIN. REG. (Dec. 13, 2014), *available at* http://corpgov.law.harvard.edu/2014/12/13/basel-committee-adopts-net-stable-funding-ratio/.

6 Notice at 1.

7 The LCR also looks at a 30-day period.

- Operational items such as clearing deposits were assumed to dramatically increase;
- Customer withdrawals of free credit balances over the period were assumed to significantly increase; and
- Trading losses were assumed to occur.

The results of these stress tests across the sample of firms revealed a wide range of preparedness. In signaling the need for more rigorous practices at broker-dealers based upon these results, FINRA suggests that firms take the following steps to implement a comprehensive liquidity risk management program tailored to the needs of a particular firm.

Management Oversight

Senior management and risk managers at firms should take steps to understand and implement a plan for handling an erosion of funding or changes in counterparty business due to stressed conditions. In order to be ready with a comprehensive plan to mitigate funding risks, FINRA expects management to develop a system to review and understand sources of funding and the liquidity process, as well as the scenarios in which those sources may become limited or completely unavailable. This process also should include an assessment of the liquidity risk associated with each new product marketed to customers.

Risk Measurement

Firms should ensure that their systems appropriately calculate cash outflows under particular stress scenarios and that these calculations are reported to senior managers who will then determine how to address liquidity stress when it arises.

Stress Testing

Each firm should conduct regular stress testing appropriate to its size and business activities that incorporates issues seen in recent and historical market events. These regular stress tests should form part of each firm's overall governance process and liquidity risk management plan. The tests should apply a range of potential shocks to assess the firm's needs during different types of stressed environments with clear differentiation for normal business activities versus contingent funding due to a significant stress scenario. In particular, the Notice asks each firm to assess a stress scenario that it might face, as well as a scenario derived from actual events at another broker-dealer with a similar business model.

Sources of Funding

As counterparties may limit or discontinue funding or apply greater collateral haircuts during stress events, firms should assess how their lenders and other sources of funding may react, including by considering reasonable haircut ranges for assets. Furthermore, firms should understand the potential effects of the Fixed Income Clearing Corporation general collateral finance facility capacity limit to determine how to allocate access to different sources of funding. By gaining a more complete understanding of their funding sources, and seeking new sources, firms will maintain better preparedness for stress conditions.

Contingent Funding

FINRA's guidance also indicates that firms should have a well-developed contingent funding plan. This plan should include a committed facility dedicated specifically to the firm, rather than one committed to multiple affiliates, as this could limit its availability during a stress event. Any third-party lending facilities with restrictions that may impede the availability of funding should be excluded from the plan. Finally, a firm should be at the ready to quickly meet any conditions precedent to a drawdown.

Liquidation

A firm's liquidity risk management program should include a cushion for losses in inventory positions. This suggestion is, in part, based on the concern that firms may need to substantially mark down the value of less liquid securities in order to sell them quickly in a stressed environment. In the Notice, FINRA states that firms should give consideration to selling less liquid securities, as well as more marketable positions such as government securities or highly rated corporate debt, when needing to increase liquidity.

Customer Withdrawal of Funds

Daily computations of customer reserve account requirements appear to be expected under the Notice, as many of the observed firms indicated that they could conduct daily computations in a stressed environment.

CONCLUSION: FINRA CONSIDERS LIQUIDITY RISK PLANNING IMPORTANT TO FIRM FINANCIAL HEALTH

In creating this expectation that firms pay attention to liquidity risk management, FINRA relies on the notions underlying the traditional broker-dealer financial responsibility rules[8] as well as broad investor protection themes.[9] The Notice stands as FINRA's most definitive statement yet on the topic and provides a roadmap for compliance. Broker-dealers can expect FINRA's examination protocols to include these issues going forward, particularly for firms that are self-clearing or act as clearing brokers. Broker-dealers that clear through others would seem to have less to consider from the Notice because they rely on the liquidity and capital positions of their clearing brokers. Nevertheless, with FINRA adding this new dimension to financial responsibility, there may be an associated increase in costs for the industry and its customers.

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Please do not hesitate to contact us with any questions.

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8 Rule 15c3-1 and Rule 15c3-3 under the Securities Exchange Act of 1934. *See* 17 C.F.R. 240.15c3-1; 17 C.F.R. 240.15c3-3. *See also* Lee A. Schneider, Gregory J. Lyons, Satish M. Kini & Samuel E. Proctor, *Debevoise discusses SEC Amendments to Financial Responsibility and Custody Rules*, CLS BLUE SKY BLOG (Sept. 5, 2013), *available at* http://clsbluesky.law.columbia.edu/2013/09/05/debevoise-discusses-sec-amendments-to-financial-responsibility-and-custody-rules/.

9 Notice at 3 (citing two prior FINRA Regulatory Notices, 10-57 and 99-92, which discussed liquidity practices).