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HAUNTINGLY FAMILIAR: RECENT DEVELOPMENTS AFFECTING THE DISTRIBUTION OF INSURANCE PRODUCTS

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"Our enforcement program also emphasizes the importance of a strong compliance program. We do this by highlighting in our orders situations where a compliance program operated effectively in identifying misconduct; by bringing enforcement actions when those programs have failed, particularly in the investment adviser realm where there is a specific requirement for compliance policies and procedures; and by requiring independent consultants in appropriate cases to ensure that compliance policies are crafted to guard against misconduct recurring."

Opening Remarks by Mary Jo White, Chairman, Securities and Exchange Commission, at the Compliance Outreach Program for Broker-Dealers, Washington, D.C. (July 15, 2015).

* * *

"FINRA reaffirms that there is little room in the industry for lax supervision and that it will not hesitate to order firms to review and correct substandard supervisory systems and controls, and pay restitution to affected customers."

Remarks of Brad Bennett, FINRA Executive Vice President and Chief of Enforcement, in FINRA press release announcing sanctions against a firm for "widespread supervisory failures" (May 6, 2015).

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I. INTRODUCTION

Distribution plays a significant role in the insurance product business. To be successful, insurers require a sales force that understands both the insurance products and the consumers who purchase the products. On the securities side, distribution of many insurance products is heavily regulated by the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority, Inc. ("FINRA"), formerly the National Association of Securities Dealers, Inc. ("NASD"). On the insurance side, state insurance regulators regulate insurers and approve insurance products, including their distribution, as well as require the licensing and appointment of insurance producers.

This outline (i) presents an overview of recent securities law developments – primarily from late 2014 through the end of September 2015 – affecting the distribution of insurance products, (ii) reviews select enforcement actions for the same period, and (iii) recaps SEC and FINRA 2015 regulatory and examination priorities impacting the marketing and distribution of insurance products.

Thematically, the distribution developments addressed in this outline fall under hauntingly familiar categories: adequacy of disclosure, statements made by registered representatives, suitability of recommendations, supervision, senior investors, conflicts of interest, compensation structures and other sales practice issues.

II. COMMUNICATIONS WITH THE PUBLIC

A. Background

FINRA (then the NASD) first adopted its communications rules in December 1980. *See* NASD Notice to Members 80-63 (announcing SEC approval of Article III, Section 35, of the NASD Rules of Fair Practice, later codified as Rule 2210). FINRA has amended its communications rules, including its variable product guidelines, many times over the years. In 2014, FINRA commenced a retrospective review of its communications rules.

B. FINRA Retrospective Rule Review

1. **Retro Phases.** In April 2014, FINRA initiated a retrospective review of its communications rules to assess their effectiveness and efficiency. *See* FINRA Regulatory Notice 14-14 (April 2014). FINRA sought to look back to determine whether the communications rules are meeting their intended investor-protection objectives. The review consisted of two phases: (i) an assessment phase and (ii) an action phase.

    - In the ***assessment phase***, FINRA assessed the efficacy and efficiency of the rules; sought answers to several questions concerning firms' experience with the rules; sought input from advisory committees, subject matter experts, and other stakeholders; reported its findings to the Board of Governors; and made staff recommendations as to whether the rules should be maintained as is, modified or deleted.

- During the ***action phase,*** FINRA has engaged in its usual rulemaking process and proposed amendments to the rules based on the findings.

2. **Rule Set Reviewed.** FINRA reviewed the following communications rule set:

FINRA 2210	→	Communications with the Public
FINRA 2212	→	Use of Investment Company Rankings in Retail Communications
FINRA 2213	→	Requirements for the Use of Bond Mutual Fund Volatility Ratings
FINRA 2214	→	Requirements for Use of Investment Analysis Tools
FINRA 2215	→	Communications with the Public Regarding Securities Futures
FINRA 2216	→	Communications with the Public Regarding Collateralized Mortgage Obligations

3. **Assessment Phase: Notice and Comment Process.** In Regulatory Notice 14-14, FINRA sought responses to the following questions:

- Have the rules effectively addressed the problem(s) they were intended to mitigate?
- What have been firms' experiences with the rule set, including any ambiguities in the rules or challenges to comply with them?
- What have been the costs and benefits arising from the rules? Have the costs and benefits been in line with expectations described in the rulemaking?
- Can FINRA make the rules more efficient and effective, including FINRA's administrative processes?

FINRA received and analyzed 17 comments from stakeholders in response to Regulatory Notice 14-14. It also interviewed "firms and individuals who have direct and substantial experience with the rules." A sample of comments included the following:

- ***Securities Industry & Financial Markets Association ("SIFMA").*** SIFMA urged FINRA "to consider ***a more principles-based and risk-based approach*** to communications with the public, especially with respect to filing requirements and supervisory pre-review requirements." SIFMA also encouraged FINRA "to provide more transparency about how its staff interprets its rules. We believe the communications with the public area is a particularly strong candidate for this approach." Further, SIFMA suggested that FINRA "harmonize its current Rule 2210(d)(1)(F), which bans predictions and projections, with the SEC investment adviser standard contained in Investment Advisers Act Section 206 and Rule 206(4)-1." *See* Letter to Marcia E. Asquith (FINRA) from Kevin A. Zambrowicz (SIFMA) (May 23, 2014).

- ***Investment Company Institute ("ICI")***. The ICI recommended, among other things, that FINRA do the following:

  - ***Electronic Media.*** Consider ways to: "(i) modernize procedural filing requirements to reduce filing and review costs and burdens; and (ii) limit duplicative filings of retail communications that essentially differ in media format only."

  - ***Investment Analysis Tools.*** Provide "additional clarity with respect to the use of output from investment analysis tools within educational materials. We also urge FINRA to consider taking a more flexible approach with respect to the disclosure requirements of Rule 2214 (Requirements for the Use of Investment Analysis Tools)."

  - ***Streamline Advertisements.*** Permit members and investors "to make full use of current technology (*e.g.,* by allowing greater use of hyperlinks to convey appropriate disclosures to investors)."

  - ***Consistency and Timeliness in Review Process.*** Continue to "consider ways in which it might improve consistency and timeliness in connection with its reviews."

  - ***Closed-End Funds***. Consider "codifying a set of clear disclosure standards tailored to closed-end fund marketing materials and then eliminating the Rule 2210 filing requirement for these communications."

See Letter to Marcia E. Asquith (FINRA) from Dorothy Donohue (ICI) (May 23, 2014).

- ***Financial Services Roundtable ("FSR").*** The FSR proposed "a principles-based approach that would provide guidance on written communications through the use of broad content standards that are flexible and forward-looking enough to address new products as they arise." According to FSR, this approach would make compliance with the FINRA Rules less burdensome. In addition, FSR noted that "the blanket prohibition in FINRA Rule 2210(d)(1)(F) against predictions or projections of investment performance inhibits customers from receiving the valuable information that they often demand." *See* Letter to Marcia E. Asquith (FINRA) from Richard Foster (FSR) (May 22, 2014).

4. **<u>FINRA Retro Survey</u>.** As a means to collect broad feedback on the observations provided through its interviews of industry participants, FINRA sent a survey to all member firms (approximately 4,200 firms) and 40 subject matter experts ("SMEs"); 626 member firms partially or fully responded and 13 SMEs responded. In response, FINRA issued a *Retrospective Rule Review Report on Communications with the Public* (Dec. 2014) ("Communications Report"), discussed below. The below charts illustrate certain results discussed in the Communications Report.

Views on the Effectiveness of Filing Requirements	
Survey Question	**All Respondents**
Filing requirements are justified for investor protection	66%
Filing requirements are overbroad	32%
Additional filing requirements are needed to enhance investor protection	2%

Source: Communications Report at 6-7.

FINRA asked follow-up questions about concerns with certain filing requirements. FINRA asked the following questions to determine which filings were overbroad:

Views on the Effectiveness of Filing Requirements	
Follow-Up Survey Question	**Concern About Filing Requirements**
Retail communications concerning registered investment companies are overbroad	58%
Prior to use filing requirement for new member firms is overbroad	32%
Prior to use filing requirement for retail communications concerning collateralized mortgage obligations is overbroad	24%
Generic investment company retail communications should be excluded from the filing requirements	71%

Source: Communications Report at 7.

FINRA received views on whether or not the filing requirements should be expanded to include additional products. Only 22% responded that FINRA should require member firms to file communications that apply to other types of investments or services. Of those respondents, more than 70% of those responding in the affirmative indicated that communications "applying to private placements, penny stocks and real estate investment trusts (REITs) should be filed with FINRA." *Id.*

Views on Risk and Comparison Disclosures		
Survey Question	**Risk Disclosures**	**Comparison Disclosures**
The amount and content of the required disclosures are appropriate for the investor protection they provide	59%	64%
The required disclosures are over-inclusive and	39%	35%

Views on Risk and Comparison Disclosures		
Survey Question	**Risk Disclosures**	**Comparison Disclosures**
disproportionately large for the investor protection they provide		
FINRA should consider increasing the disclosure requirements to enhance investor protection	2%	2%
Total Respondents	551	544

Source: Communications Report at 7.

Views on the Content Standards	
Survey Question	**All Respondents**
Content standards are clear and can be applied objectively and consistently	~ 60%
Content standards are too broad, subjective and difficult to understand	~ 40%

Source: Communications Report at 8.

Views on Social Media and Mobile Communications				
Survey Question	**Agree**	**Neutral**	**Disagree**	**Total Respondents**
FINRA should provide increased flexibility and clarity on the application of its rules to social media and mobile communications	67%	27%	6%	527

Views on Social Media and Mobile Communications				
Survey Question	**Agree**	**Neutral**	**Disagree**	**Total Respondents**
FINRA rules should provide increased flexibility on the presentation of disclosures for communications on websites and mobile devices	64%	30%	6%	524
FINRA should provide more guidance on how to distinguish between static and interactive content	53%	40%	6%	521
FINRA should clarify firms' obligations with respect to links to content on third-party websites and posting third-party content on the firm's website	63%	34%	3%	522

Source: Communications Report at 9-10.

Views on Direct Costs Associated With Communications Rules				
Survey Question	**All Respondents**	**Responding Members with**		
		No Filings	**100 or fewer filings**	**101 or more filings**
Direct costs are reasonable for the investor protection the rules provide	56%	58%	56%	43%
Direct costs are disproportionately burdensome for the investor protection the rules provide	37%	34%	39%	55%
Direct costs are small relative to the investor protection the rules provide	7%	8%	5%	2%
Total Respondents	475	306	125	44

Source: Communications Report at 11-12.

5. **<u>FINRA Communications Report – Conclusions</u>.** FINRA issued its Communications Report in December 2014. The report concluded that "the rules have largely been effective in meeting their intended investor protection objectives. . . . [but] the rules and FINRA's administration of them ***may benefit from some updating and recalibration to better align the investor protection benefits and the economic impacts***." Communications Report, *supra,* at 12. FINRA staff recommended consideration of the following areas of general agreement among stakeholders:

- "aligning the filing requirements and review process with the relative risk of the communications;
- facilitating simplified and more effective risk disclosure;
- providing more guidance regarding application of the content standards, including exploring the adoption of comprehensive performance standards;
- adapting rules and guidance in light of emerging technologies and communications innovation; and
- updating FINRA's electronic filing system."

6. **<u>Action Phase: Proposed Communication Rule Changes</u>.** In May 2015, FINRA solicited comment on proposed rule changes in response to its Communications Report. *See* FINRA Regulatory Notice 15-16, *FINRA Requests Comment on Proposed Amendments to Rules Governing Communications with the Public* (May 2015). The proposed amendments would amend FINRA Rules 2210, 2213 and 2214 as follows:

- ***New Firm Filing Requirements.*** For a period of one year – beginning on the date when a new firm's FINRA membership became effective – a new member currently must file with FINRA at least 10 business days prior to first use any retail communication. Under the proposed rule, new firms would be required to file ***only their websites*** and material changes to their websites within 10 business days of first use for a one-year period. *See* Rule 2210(c)(1)(A)&(B).
- ***Investment Company Shareholder Reports.*** FINRA members currently are required to file with FINRA the manager's discussion of fund performance ("MDFP") section if the section is released or is obtainable by investors. FINRA has proposed excluding shareholder reports that have been filed with the SEC from the

filing requirements because investment companies already must file shareholder reports with the SEC, and because the MDFP typically presents less investor risk than other types of promotional communications concerning investment companies. *See* Rule 2210(c)(7)(F).

- ***Backup Material for Investment Company Performance Rankings and Comparisons.*** FINRA has proposed eliminating the requirement to file ranking and comparison backup material and instead expressly require firms to maintain back-up materials as part of their records. *See* Rule 2210(b)(4)(vi).

- ***Generic Investment Company Retail Communications.*** FINRA members currently are required to file generic retail communications within 10 business days of first use. FINRA has proposed excluding from the filing requirements generic investment company retail communications that do not promote or recommend a specific fund or fund family. *See* Rule 2210(c)(3)(A).

- ***Investment Analysis Tools.*** FINRA has proposed eliminating the filing requirements for investment analysis tool report templates and retail communications concerning such tools in light of the investor protection afforded by other content standards and the requirement that firms provide access to the tools and their output upon request of FINRA staff. *See* Rule 2214(a).

- ***Template Filing Exclusion.*** FINRA has proposed expanding the template filing exclusion to allow firms to include updated non-predictive narrative descriptions of market events during the period covered by the communication and factual descriptions of portfolio changes without having to refile the template. *See* Rule 2210(c)(7)(B).

- ***Bond Mutual Fund Volatility Ratings.*** Firms currently must file retail communications that include bond mutual fund volatility ratings at least 10 business days prior to first use. FINRA has proposed permitting firms to file these communications within 10 days of first use rather than prior to use. The proposal also streamlines the content and disclosure requirements. *See* Rules 2210(c)(2) and 2213.

7. **<u>Action Phase: Comments on Proposed Rule Changes</u>.** FINRA received 11 comments from stakeholders in response to Regulatory Notice 15-16, including the following:

- ***SIFMA* – "**SIFMA believes the proposed amendments will make FINRA's communications with the public rules less burdensome to the industry and more beneficial to investors by, among other things, eliminating unnecessary and duplicative filing requirements and leveraging information that is already available. . . . [however, to make] compliance with the rules less costly. . . SIFMA suggests one additional change to FINRA Rule 2210(d)(1)(C) regarding the use of legends and footnotes relating to mobile devices." *See* Letter to Marcia E. Asquith (FINRA) from Kevin Zambrowicz and Stephen Vogt (SIFMA) (July 2, 2015).

- ***ICI* –** While ICI supports FINRA's proposal, it provided additional recommendations, including the following:

  - "Clarify that a firm may rely on the proposed FINRA filing exclusion for shareholder reports if the firm files them in compliance with applicable SEC requirements."

  - "Further expand the proposed filing exclusion for retail communications based on templates previously filed with FINRA to also include updates to: (i) narrative information that is based on disclosure contained in certain SEC filings (*e.g.,* fund prospectuses); (ii) narrative factual information provided by a "ranking entity;" and (iii) market- and investment-related commentary."

  - "For closed-end funds, codify a set of clear disclosure standards tailored to their retail communications and eliminate the current filing requirement."

  See Letter to Marcia E. Asquith (FINRA) from Dorothy Donohue (ICI) (July 2, 2015).

8. **<u>Action Phase: Guidance on Communication Rules</u>.** In May 2015, FINRA issued guidance on its communications rules in the form of additional questions and answers on the FINRA website Advertising Regulation page. *See* FINRA Regulatory Notice 15-17 (May 2015), which includes a link to the questions and answers, *available at* http://www.finra.org/industry/finra-rule-2210-questions-and-answers. The questions and answers supplement previously published guidance and tackle areas discussed in the Communications Report that were not part of the proposed rule changes, including the following topics:

   - non-promotional communications;
   - social media posts in online interactive forums;
   - filing exclusions for templates;

- filing exclusion for non-material changes to previously filed retail communications;
- article reprints;
- institutional communications;
- Rule 482 issues;
- disclosure of expense reimbursement arrangements in mutual fund performance advertising; and
- business development companies.

III. GIFTS AND NON-CASH COMPENSATION

A. Background

FINRA Rule 3220 (*Influencing or Rewarding Employees of Others*) is known as the "Gifts Rule." It prohibits, among other things, any firm or associated person, directly or indirectly, from giving anything of value ***in excess of $100 per year*** to any person where the payment is in relation to the business of the recipient's employer. Pursuant to FINRA interpretative guidance, the Gifts Rule does not prohibit "***ordinary and usual business entertainment***." *See* Letter from R. Clark Hooper (NASD) to Henry H. Hopkins and Sarah McCafferty (T. Rowe Price Investment Services, Inc.) (June 10, 1999). Similarly, 1998 amendments to NASD Rule 2820 (*Variable Contracts of an Insurance Company*) and 2830 (*Investment Company Securities*) as well as 2003 amendments to NASD Rules 2710 (*Corporate Financing Rule – Underwriting Terms and Arrangements*) and 2810 (*Direct Participation Programs*), respectively, imposed new requirements on non-cash compensation arrangements and codified substantially similar requirements on non-cash compensation arrangements. As a result of the amendments, member firms and associated persons are prohibited from directly or indirectly accepting or making payments of any non-cash compensation, subject to specified exceptions.

B. FINRA Retrospective Rule Review

1. **Retro Goals.** In April 2014, FINRA initiated a retrospective review of its gifts, gratuities and non-cash compensation rules. *See* FINRA Regulatory Notice 14-15 (April 2014). FINRA designed the retrospective review process to determine whether current FINRA Rules (i) protect investors in efficient and relevant ways, and (ii) achieve their original objectives making an allowance for the current regulatory climate. *Id.* at 2.

2. **Rule Set Reviewed.** FINRA analyzed the following gift and compensation rule set:

FINRA 3220 *(formerly NASD 3060)*	→	Influencing or Rewarding Employees of Others

FINRA 2310(c) *(formerly NASD 2810)*	→	Direct Participation Programs
FINRA 2320(g)(4) (*formerly NASD 2820)*	→	Variable Contracts of an Insurance Company
FINRA 5110(h) *(formerly NASD 2710)*	→	Corporate Financing Rule – Underwriting Terms and Arrangements
NASD 2830(l)(5)	→	Investment Company Securities

3. **<u>Assessment Phase: Notice and Comment Process</u>.** In Regulatory Notice 14-15, FINRA sought responses to the following questions:

- Have the rules effectively addressed the problem(s) they were intended to mitigate?
- What have been firms' experiences with implementation of the rule set, including any ambiguities in the rules or challenges to comply with them?
- What have been the costs and benefits arising from FINRA's rules? Have the costs and benefits been in line with expectations described in the rulemaking?
- Can FINRA make the rules more efficient and effective, including FINRA's administrative processes?

FINRA received and analyzed comments from 11 stakeholders. It also interviewed firms and individuals "who have direct and substantial experience with the rules." A sample of comments included the following:

- ***SIFMA*** – " [W]e believe these rules have been effective at limiting conflicts of interest on the part of both clients and registered representatives. . . .These rules must be ***centralized in a single place in the FINRA rulebook***. We recommend that FINRA also consider whether these rules should be applied consistently ***to all securities products***, rather than (as today) just to investment company securities, variable products and public offerings of securities." SIFMA also advocated for a ***principles based approach*** to gifts, entertainment, and non-cash compensation as opposed to hard values. Letter to Marcia E. Asquith (FINRA) from Kevin A Zambrowicz (SIFMA) (May 23, 2014) (emphasis added).

- ***ICI*** – The ICI recommended that FINRA incorporate ***a principles-based provision instead of the current exemption categorization model***, because formal supervisory control procedures in place "may sufficiently address many of the concerns underlying the entertainment and training provisions. As a result, there may no longer be a compelling need to address such concerns by specifically requiring members to categorize events as either entertainment, training, or a prospecting trip." The ICI also recommended that FINRA ***revise the nominal gift provision*** with a process to account for future increases. In particular, ICI recommended that "the rule require FINRA, no less frequently than every five years, to revisit the annual amount of permissible gifts per person and make increases as warranted, taking into account the effect of inflation and other factors as appropriate." *See* Letter to Marcia E. Asquith (FINRA) from Tamara K. Salmon (ICI) (May 23, 2014).

4. **FINRA Retro Survey.** As a means to collect broad feedback on the observations provided through its interviews of industry participants, FINRA sent a survey to all member firms (approximately 4,200 firms) and 38 subject matter experts (SMEs); 598 member firms and 9 SMEs responded. In response FINRA issued a *Retrospective Rule Review Report on Gifts, Gratuities and Non-Cash Compensation* (Dec. 2014) ("Gifts Report"). The chart below illustrates certain survey results discussed in the Gifts Report:

Survey Question	Agree & Strongly Agree	Disagree & Strongly Disagree	Neutral
Rules are achieving policy concerns	48%	14%	
FINRA guidance and interpretive positions are clear and helpful	47%	14%	
FINRA should update the current rules and provide additional guidance	65%		35%
$100 gift limit (in place since 1992) is too low	"strong agreement"	6%	
Dollar gift limit versus principles-based approach to establish limits	47% dollar limit vs 26% principles based		
Need for greater clarity on charitable events or donation rules	68%		

Survey Question	Agree & Strongly Agree	Disagree & Strongly Disagree	Neutral
Need for greater clarity on personal versus professional gifts	65%		
Permit entertainment at training or educational meetings	56%		
Rules should be applied to all securities products	"most respondents"		
Recordkeeping costs outweigh the benefits	"no consensus"	"no consensus"	

N.B. The above chart compiles response percentages discussed in FINRA's Gifts Report. If the Gifts Report was silent on a response percentage, the corresponding box above is left empty.

5. **FINRA Gifts Report Conclusions.** Based on the information obtained, FINRA recommended in the Gifts Report exploring a combination of guidance and proposed rule modifications in the following areas:

- updating the existing guidance and addressing issues not covered by prior Notices;
- consolidating FINRA rules governing gifts and non-cash compensation into a single rule governing both topics;
- amending the non-cash compensation rules to cover all securities products;
- increasing the current limits on gifts from $100 per person per year, including a *de minimis* threshold below which firms would not have to track gifts given or received, and creating exceptions for gifts related to life events;
- creating a single rule governing business entertainment in all contexts, rather than having multiple rules depending on the products involved; and
- providing firms and product sponsors with more flexibility regarding the locations of training or education meetings, permitting firms and sponsors to include limited entertainment as part of training or education meetings, and publishing guidance that gives examples of permissible and impermissible training or education meetings.

C. Senator Elizabeth Warren Letters and Industry Reaction

1. **Background – Inquiry Letters**. Apart from FINRA's retrospective review of its gifts and non-cash compensation rules, earlier this year Senator Elizabeth Warren (D., Mass.) initiated a probe targeting sales incentives for annuities.[2] On April 28, 2015, Senator Warren sent identical letters to 15 companies with the highest 2014 U.S. individual annuity sales. She raised concerns about the rewards and incentives offered to brokers and dealers who sell annuities to families and small investors.[3] Senator Warren's letters quote from marketing materials aimed at insurance agents with a record of high-volume annuity sales, describing sales incentives including trips, cash awards, and car leases.[4] Senator Warren asked annuity providers for information about the incentives they offer; the number and value of the incentives awarded; and the companies' policies for disclosing these potential conflicts of interest.

   While Senator Warren's letters refer only to "annuities" – and not fixed annuities or variable annuities by name – her focus may be on fixed indexed annuities[5] inasmuch as variable annuities are subject to FINRA rules governing non-cash compensation, which effectively regulate many, if not all, of the incentives Senator Warren identifies in her inquiry. *See* FINRA Rule 2320(g)(4).

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[2] *See* Press Release, *Senator Elizabeth Warren, Senator Warren Launches Investigation of Rewards and Incentives Offered to Annuities Dealers Advising Retirees* (Apr. 28, 2015), *available at* http://www.warren.senate.gov/?p=press_release&id=800.

[3] A PDF copy of the letters is *available at*: http://www.warren.senate.gov/files/documents/AnnuitiesLetters.pdf. The letters were sent to Jackson National Life, AIG Companies, Lincoln Financial Group, Allianz Life, TIAA-CREF, New York Life, Prudential Annuities, Transamerica, AXA USA, MetLife, Nationwide, Pacific Life, Forethought Annuity, Riversource Life Insurance, and Security Benefit Life.

[4] Examples of the kinds of incentives Senator Warren included in her letters are *available at*: http://www.warren.senate.gov/files/documents/AnnuityExamples.pdf.

[5] In the first quarter of 2015, sales of indexed annuities rose 3% from the year-earlier quarter, to $11.6 billion, when total U.S. annuity sales fell 7% to $54.4 billion, according to LIMRA, a research firm funded by the insurance industry. *See* Press Release, LIMRA Secure Retirement Institute, LIMRA Secure Retirement Institute Reports Decline in Annuity Sales in First Quarter 2015 (May 19, 2015), *available at* http://www.limra.com/Posts/PR/News_Releases/LIMRA_Secure_Retirement_Institute_Reports_Decline_in_Annuity_Sales_in_First_Quarter_2015.aspx. *See also* LIMRA Secure Retirement Institute, U.S. Individual Annuity Sales Survey (2015, 1st quarter), *available at* http://www.limra.com/uploadedFiles/limra.com/LIMRA_Root/Posts/PR/Data_Bank/_PDF/2015-1Q-Annuity-Estimate%20final.pdf. However, sales of indexed annuities dropped 3% between the second quarter of 2014 and the second quarter of 2015, while total U.S. annuity sales fell 5% from the year-earlier quarter. *See* LIMRA Secure Retirement Institute, U.S. Individual Annuity Sales Survey (2015, 2nd quarter), *available at* http://www.limra.com/Posts/PR/Data_Bank/_PDF/Annuity-2Q-2015-Estimates.aspx.

2. **Industry Response.** On the same day, both the Insured Retirement Institute ("IRI") and the ACLI responded by releasing statements. In its statement, the IRI noted as follows:

> "Annuities are an important option for many consumers as part of their holistic retirement plans. These are the only offerings on the market that can provide tax-deferred retirement savings, upside growth with downside protection, and guaranteed income throughout one's lifetime. Annuities also come with a free-look period, in which new contract owners can terminate their contract without penalty. It also should be noted that IRI research shows nine in 10 annuity owners are satisfied with their annuity-based investment.
>
> Almost all financial professionals who are IRI members hold both insurance and securities licenses and must adhere to a robust framework of consumer protections (at both the state and federal levels) that oversee the distribution of annuity products. IRI and its members expect all financial professionals to meet the requirements of these laws and regulations – no exceptions. IRI supports FINRA's annuity suitability rules and furthermore supports the uniform adoption, across all states, of the NAIC Annuity Suitability Model, the NAIC Annuity Disclosure Model and the NAIC Senior Designations Model. These rules all require sales practices that provide suitable financial products given an investor's individual needs. These rules, combined with other mandated education and oversight requirements, foster a best practice environment for financial professionals."

See Statement, Insured Retirement Institute, *IRI: Robust Framework of Consumer Protections Oversee Distribution of Annuity Products* (Apr. 28, 2015), *available at* http://www.irionline.org/newsroom/newsroom-detail-view/iri-robust-framework-of-consumer-protections-oversee-distribution-of-annuity-products.

In its statement, the ACLI noted, among other things, as follows:

> "From product development to advertising to sales, life insurers offering annuities must comply with state and federal laws and rules that help protect consumers' interests. As insurance products, annuities are regulated by the states that have laws and regulations for the content and marketing of the product. State regulations include extensive product disclosure, strong suitability standards, as well as truth-in-advertising and credentialing requirements. The [SEC] enforces strict antifraud prohibitions. [FINRA] sets rules that govern the sales practices of broker-dealers."

See Comprehensive Regulations Protect Consumers' Interests In Annuity Sales, ACLI Comment on Sen. Elizabeth Warren's Request for Annuity Sales Information (Apr. 28, 2015) (discussion of state and federal laws omitted), *available at* https://www.acli.com/Newsroom/News%20Releases/Pages/NR15-022.aspx.

IV. PRIVATE SECURITIES TRANSACTIONS

A. Background – NASD Rule 3040

1. **Requirements of the Rule.** NASD Rule 3040 – *Private Securities Transactions of an Associated Person* – is commonly known as the "selling away rule." Prior to participating in any private securities transaction, Rule 3040 requires associated persons to provide ***written notice*** to the member with which he/she is associated describing in detail (i) the proposed transaction; (ii) the person's proposed role therein, and (iii) whether he/she has received or may receive selling compensation in connection with the transaction.

2. **Compensation.** Rule 3040 distinguishes between transactions for compensation and transactions not for compensation. If selling compensation will be received, the broker-dealer must advise its associated person ***in writing*** whether the person's participation in the transaction is approved or not approved. If the associated will not receive selling compensation, the broker-dealer must provide the associated person with prompt written acknowledgement and may require the associated person to adhere to specific conditions in connection with the associated person's participation in the transaction.

3. **Books, Records and Supervision.** If a broker-dealer approves an associated person's participation in the private securities transaction, (i) the transaction must be recorded on the broker-dealer's books and records, and (ii) the broker-dealer must supervise the person's participation in the transaction.

B. Proposed FINRA Rule 3280

1. **Background.** In FINRA Regulatory Notice 08-24 (May 2008), FINRA solicited comments for substantive changes to Rule 3040. Among other things, FINRA proposed that an associated person would be required to "obtain the member firm's prior written approval before engaging in any outside investment banking or securities business, ***regardless of whether the associated person receives any compensation*** . . ." Rule 3040 currently does not so require ***prior written approval*** for transactions not

for compensation. Rather, as discussed above in § IV.A.2., Rule 3040(d) requires "***prompt written acknowledgement***" and permits the firm to impose conditions in connection with the associated person's participation in the transaction.

2. **<u>Scope of Proposed Rule</u>.** On August 20, 2015, FINRA filed with the SEC a proposed rule change to adopt FINRA Rule 3280 in the consolidated FINRA rulebook ***without any substantive change***. *See* File No. SR-2015-30 (Aug. 20, 2015). The rule proposal notes that "FINRA may consider proposing substantive changes to the rule as part of future rulemaking." *Id.*

3. **<u>Status of FINRA Rule 3280</u>.** On August 25, 2015 the SEC issued a Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Adopt FINRA Rule 3280. Securities Exchange Act Release No. 75757, 80 Fed.Reg. 168 at 52530 (Aug. 31, 2015). The Notice sought submission of comments on or before September 21, 2015. As of the date of this outline, no further action had been taken on proposed Rule 3280.

V. ASSOCIATED PERSON ACCOUNTS HELD WITH OTHER BROKER-DEALERS

A. <u>Background – NASD Rule 3050</u>

1. **<u>Accounts Held With Another Broker-Dealer</u>.** NASD Rule 3050 provides that if ***an associated person of an employer member broker-dealer*** wishes to open a securities account and effect securities transactions through another broker-dealer (an executing broker-dealer), the associated person must ***notify both the respective employer member and the executing broker-dealer***, in writing of his or her association with the employer member prior to opening the account or placing an initial order for the purchase or sale of securities with the executing broker-dealer. Rule 3050(c). This obligation also applies to accounts in which the associated person has or will have a financial interest and to accounts over which the associated person has discretionary authority. Once the executing broker-dealer has knowledge of the individual's association with the employer member, ***the executing broker-dealer must***:

   a. notify the employer member in writing, prior to the execution of a transaction for such account, of the executing broker-dealer's intention to open or maintain such an account;

   b. ***upon written request by the employer member***, transmit duplicate copies of confirmations, statements, or other information ("Duplicates") with respect to such account; and

c. notify the person associated with the employer member of the executing broker-dealer's intention to provide the notice and information required by (a) and (b) above. Rule 3050(b) (emphasis added).

2. **Accounts with Investment Advisers, Banks, or Financial Institutions.** Where an associated person of an employer member intends to open an account with or effect transactions through a non-broker-dealer financial institution, *e.g.*, a registered investment adviser, the associated person is only required to notify the employer member in writing, prior to execution of any initial transactions, of the intention to open the account or place the order. Rule 3050(d). Then, "***upon written request by the employer member***," ***the associated person must*** "request in writing and assure the . . . investment adviser . . . provides the employer member with [Duplicates] concerning the account or order." *Id.* (emphasis added).

3. **Duplicates.** There is no requirement that employer members submit requests for Duplicates. This fact reflects a long-standing recognition by FINRA that broker-dealers may utilize a risk-based approach in obtaining account records for associated persons' personal securities accounts, consistent with the requirement that a broker-dealer's supervisory structure be reasonably tailored to the business actually conducted by the broker-dealer.[6]

B. Proposed FINRA Rule 3210

1. **Initial Proposal.** In April 2009, FINRA proposed consolidated FINRA Rule 3210 to replace both NYSE Rule 407 and NASD Rule 3050. *See* FINRA Regulatory Notice 09-22 (Apr. 2009). As initially proposed, Rule 3210 would combine and streamline certain provisions of each rule and would be based in large part on NYSE Rule 407, which has more rigid requirements, particularly for most insurance-affiliated broker-dealers that "are not NYSE members and are not currently required to gather these documents under Rule 3050." *See* ACLI Letter, *supra* note 6, at 5. The initial proposal would have ***required*** employer members to obtain Duplicates for their associated persons. *See* Notice 09-22 at 3-4. *See also* ACLI Letter, *supra* note 6, at 2.

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[6] *See* ACLI Comment Letter to Proposed FINRA Rule 3210, at 1 (June 5, 2009), *available at* https://www.finra.org/sites/default/files/NoticeComment/p118942.pdf (the "ACLI Letter") ("Existing NASD Rule 3050 provides an appropriate risk-based approach to monitoring associated persons' personal securities transactions that functions well for many broker-dealers, such as insurance-affiliated broker-dealers, that have structures, operation[s] and functions different from, and substantially more limited than, 'wire-house' broker-dealers."). *See also* Committee of Annuity Insurers Comment Letter to Proposed FINRA Rule 3210, at 3 (June 5, 2009) (the "CAI Letter"), *available at* https://www.finra.org/sites/default/files/NoticeComment/p118943.pdf.

2. **Industry Comment.** The proposed rule prompted significant negative industry reaction.[7] Notably, industry commenters criticized the rule as unjustifiably attempting to eliminate Rule 3050's risk-based approach, which recognizes the diversity of FINRA membership and the different levels of risk posed by FINRA broker-dealers' various business models, in exchange for the imposition of one-size-fits-all requirement on all broker-dealers, regardless of their functions, products, and operations.[8]

3. **Revised Proposed Rule 3210.** In August 2015, FINRA, in response to commenters, re-proposed Rule 3210, which it revised to permit member discretion, consistent with their supervisory obligations under new FINRA Rule 3110(d) to request the specified information of executing members and non-member financial institutions, thereby permitting members reasonable flexibility to craft appropriate supervisory policies. *See* Securities Exchange Act Release No. 75655 (Aug. 10, 2015). The proposed rule change permits firms to implement supervisory procedures that align with their business models, without diminishing members' supervisory obligations with respect to the activities of their associated persons. FINRA believes that this proposed approach imposes less cost on members without reducing investor protections. In addition, the proposed rule change deletes a number of requirements in NASD Rule 3050 and NYSE Rule 407 that are rendered outdated by the proposed new rule or are otherwise addressed by other FINRA rules. FINRA recognized that providing such flexibility to members may require increased monitoring of members' compliance with this rule as part of FINRA's examination program. *Id.*

4. **Rulemaking Status.** The SEC comment period on the revised proposal ended on September 4, 2015. *See* 80 Fed.Reg. 157 at 48941 (Aug. 14, 2015). As of the date of this outline, the SEC received four comment letters. On September 22, 2015, FINRA filed with the SEC and extension of time for the SEC action on Rule 3210 until November 12, 2015.

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[7] Comment letters responding to proposed Rule 3210 are *available at*: https://www.finra.org/industry/notices/09-22.

[8] For example, the ACLI Letter states, "Nor does [the proposed rule] address the distinct differences between broker-dealers that continue to exist and were explicitly recognized by the different approaches taken on this issue by the NASD for NASD-only firms and by the NYSE for its member firms." ACLI Letter, *supra* note 6, at 2. *See also* CAI Letter, *supra* note 6, at 3 (". . . Rule 3050 has long permitted employer firms to utilize a risk-based approach in obtaining account records for outside brokerage accounts, in recognition of the diverse nature of the business operations of FINRA members . . . . [E]mployer members whose activities are limited to those of a wholesaling or introducing firm and who do not engage in the solicitation of equity trades, research or market-making . . . are not engaging in business activities warranting the collection and close review of account records for outside brokerage account transactions.").

VI. SALES OF SECURITIES AND INSURANCE ON MILITARY BASES

A. GAO Study and Report

1. **Background.** Following a 2004 investigative report by the *New York Times* that revealed that some soldiers on military bases were being sold "unnecessary insurance policies that were actually contractual plan mutual funds," the United States General Accounting Office ("GAO") commenced a study. *See* Financial Product Sales: Actions Needed to Better Protect Military Members (Nov. 2005) ("GAO Report"), *available at* http://www.gao.gov/products/GAO-06-23. Included in the GAO Report are descriptions of meetings – sometimes compulsory – where soldiers allegedly were encouraged to purchase high-cost products from salesmen who gave the appearance of being independent financial planners working on the soldiers' behalf. *See* National Association of Insurance Commissioners, Military Life Insurance Reform (Jun. 3, 2015), *available at* http://www.naic.org/cipr_topics/topic_military_life.htm.

   To assess whether military service members were adequately protected from inappropriate product sales, the GAO examined:

   - features and marketing of certain insurance products being sold to military members;
   - features and marketing of certain securities products being sold to military members; and
   - how financial regulators and the Department of Defense ("DOD") were overseeing the sales of insurance and securities products to military members.

2. **What the GAO Found.** The GAO found that thousands of junior enlisted service members had been ***sold a product that combines life insurance with a savings fund promising high returns***. The product was being marketed by a small number of companies as (i) a product capable of providing savings to service members who make steady payments, and (ii) a product that had provided millions in death benefits to the survivors of others. However, the products were much more costly than the $250,000 of life insurance – now $400,000 – that military members already receive as part of their government benefits. In addition, the products allowed any savings accumulated on these products to be used to extend the insurance coverage if a service member ever stopped making payments and did not request a refund of the savings. With most military members leaving the

service within a few years, many do not continue their payments and, as a result, few likely amassed any savings from their purchase.

Further, the GAO found that thousands of military members were also purchasing a mutual fund product that also requires an extended series of payments to provide benefit. Known as ***contractual plans***, the plan expected the service member to make payments for set periods (such as 15 years), with 50% of the first year's payments representing a sales charge paid to the selling broker-dealer. If held for the entire period, these plans can provide lower sales charges and returns comparable to those of other funds. However, with securities regulators finding that only about 10-40% of the military members who purchased these products continued to make payments, many military members paid higher sales charges and received lower returns than if they had invested in other available products.

The GAO found that financial regulators were generally unaware of the problematic sales to military members because DOD personnel rarely forwarded service member complaints to them. In particular, according to the GAO:

- insurance products also usually lacked suitability or appropriateness standards that could have prompted regulators to investigate sales to military members sooner;

- securities regulators' examinations of contractual plan sales were also hampered by lack of standardized data showing whether customers were benefiting from their purchases; and

- although recognizing a greater need for sharing information on violations of its solicitation policies and service member complaints, DOD had not revised its policies to require that such information be provided to financial regulators nor had it coordinated with these regulators and its installations on appropriate ways that additional sharing can occur.

3. **GAO Recommendations.** The GAO recommended that Congress consider (i) banning contractual plans, (ii) requesting that insurance regulators conduct reviews to ensure that products being sold to military members meet existing insurance requirements, and (iii) ensuring the development of appropriateness or suitability standards for such sales. The GAO also recommended that DOD and financial regulators work cooperatively to help improve the oversight of such products. DOD and financial regulators provided comments generally agreeing with the GAO Report and its recommendations.

B. **Military Personnel Financial Services Protection Act**

1. **Congress Takes Action.** In 2006, Congress passed the 2006 Military Personnel Financial Services Protection Act, Pub. L. No. 109-290 (Senate Bill 418), 120 Stat. 1317 (2006) ("Military Act"). The Military Act amended Section 15A(b) of the Securities Exchange Act of 1934 ("Exchange Act") by requiring self-regulatory organizations ("SROs"), including FINRA, to adopt rules governing the offer and sale of securities on the premises of any military installation to members of the U.S. Armed Forces or their dependents. The Military Act is aimed at protecting members of the military and their families from unscrupulous sales of insurance, financial and investment products.

2. **What the Military Act Does.** The Military Act bans the sale of contractual mutual funds on military bases and grants state insurance commissioners explicit authority in federal law to regulate insurance sales to military personnel, on bases in the United States and abroad, unless state regulations directly conflict with federal law or would not apply to sales conducted on state lands.

3. **State Model Regulation.** As part of the Military Act, Congress required that the states collectively work with the Secretary of Defense to ensure implementation of appropriate standards to protect members of the Armed Forces from dishonest and predatory insurance sales practices while on a military installation. State insurance regulators – along with state legislatures, the U.S. Congress, and the Department of Defense – took swift action to draft and implement, in 2007, the *NAIC Military Sales Practices Model Regulation* ("Model Regulation") and other protective measures. The Model Regulation creates standards for products specifically designed to meet the particular needs of members of the Armed Forces and addresses Congressional findings regarding suitability and product standards.

C. **FINRA Rule 2272**

1. **FINRA Proposal.** On April 23, 2015, FINRA proposed Rule 2272 to implement the Military Act requirements. *See* Exchange Act Rule 15A(b)(14). On May 6, 2015, the SEC published the proposing release to solicit comments on the proposal. Rule 2272 requires the following:

   - ***Disclosure:*** The firm shall clearly and conspicuously ***disclose in writing***, which may be electronic, to the potential investor ***prior to engaging in sales or offers*** of sales of securities to such investor: (1) the identity of the firm offering the securities; and (2) that the securities offered are not being offered or provided by the firm on behalf of the federal government and that the offer of such securities is not sanctioned, recommended or encouraged by the federal government. Electronic delivery of the disclosures required by Rule 2272(b) must be consistent with SEC guidance on the use of electronic media to satisfy delivery obligations, which, among other things, requires affirmative consent of the customer for delivery of certain documents.

- ***Suitability***: Rule 2272 incorporates the suitability obligations under FINRA's suitability rule, Rule 2111. As noted in the proposing release, "FINRA believes that the suitability obligations imposed by Rule 2111 satisfy the statutory requirement that FINRA adopt rules requiring its members to perform an appropriate suitability determination, including consideration of costs and knowledge about securities, prior to making a recommendation."

- ***Referral Fee Restrictions:*** Rule 2272 further provides that no firm shall cause a person to receive a referral fee or incentive compensation in connection with sales or offers of sales of securities on the premises of a military installation with any member of the U.S. Armed Forces or a dependent thereof, unless such person is an associated person of a registered broker-dealer who is appropriately qualified consistent with FINRA rules, and the payment complies with applicable federal securities laws and FINRA rules.

2. **SEC Approval.** On August 6, 2015, the SEC issued an order approving the proposed adoption of Rule 2272 to govern sales or offers of securities on the premises of any military installation to members of the U.S. Armed Forces or their dependents. Securities Exchange Act Release No. 75633 (Aug. 6, 2015), 80 Fed.Reg. 155 at 48376 (Aug. 12, 2015). After addressing a few commenters' concerns, the SEC approved by stating:

> In light of the statutory requirements under Section 15A(b)(14) of the Exchange Act, and the need to protect members of the U.S. Armed Forces from unscrupulous practices regarding the sales of investment products, the Commission believes that the proposed rule is consistent with the Act in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Rule 2272 becomes ***effective on March 30, 2016***. *See* FINRA Regulatory Notice 15-34 (Oct. 2, 2015).

3. **<u>Scope of Rule</u>.** Rule 2272(a) defines "military installation" to mean "any federally owned, leased or operated base, reservation, post, camp, building or other facility to which members of the U.S. Armed Forces are assigned for duty, including barracks, transient housing and family quarters." Commenters on the proposed rule had sought to have the rule apply to sales off the premises of any military installation ("off-base sales"). FINRA considered the comment and elected not to apply the rule to off-base sales because the rule is intended to comply with the requirements of Exchange Act Rule 15A(b)(14), which applies to offers and sales on base.

   The SEC agreed with FINRA that the requirements of Exchange Act 15A(b)(14) apply to on-base offers and sales. *See* Letter from Jeanette Wingler, Assistant General Counsel (FINRA), to Brent J. Fields, Secretary (SEC), dated July 21, 2015 ("FINRA Response Letter") at 3. The SEC also agreed with FINRA that offers or sales of securities off-base implicate a reduced risk of confusion as to whether those securities are endorsed or offered by the federal government. *Id.* In response to concerns by commenters that Rule 2272 should incorporate a requirement for a standardized disclosure form, FINRA and the SEC both noted that the proposed rule explicitly requires disclosures be made "in writing" and "clearly and conspicuously" before engaging in sales to avoid investor confusion. Rule 2272(b) and Release No. 75633, *supra.*

VII. HOLDING CUSTOMER CHECKS – SUBSCRIPTION-WAY TRANSACTIONS

A. <u>Background</u>

1. **<u>Subscription-Way Transactions</u>.** "Subscription way" is a common procedure whereby the check is not made payable to the broker-dealer, but is made payable to the issuer (or other designated entity) and is forwarded with an application by the broker-dealer to the issuer – such as an insurance company or investment company – or to the issuer's agent.

2. **<u>Prompt Transmittal of Customer Funds</u>.** Pursuant to Exchange Act Rule 15c3-1 (the net capital rule) and Rule 15c3-3 (the rule regarding safeguarding of customer funds), a broker-dealer is not deemed to be carrying customer funds if it "***promptly transmits***" checks to third parties. For these purposes, the SEC interprets "promptly" to mean ***no later than noon of the next business day*** after receipt of such funds or securities. But in order to perform a suitability analysis and approve the transaction as required by FINRA suitability rules, broker-dealers often need to hold checks longer than one business day.

3. **Variable Annuity Precedent.** In 2009, the SEC approved NASD Rule 2821 (now FINRA Rule 2330) governing suitability obligations regarding deferred variable annuity transactions (the "VA Suitability Rule"). The VA Suitability Rule requires a registered principal to review and approve recommended variable annuity transactions ***within seven days*** after an Office of Supervisory Jurisdiction ("OSJ") of the firm receives "a complete and correct application package." If a registered principal has determined that there is "a reasonable basis to believe that the transaction would be suitable," the principal may approve the recommended transaction. At the same time it approved the VA Suitability Rule, the SEC also issued an order, subject to conditions, granting exemptions to broker-dealers from any additional requirements of Rules 15c3-1 and 15c3-3 "due solely to a failure to promptly transmit a check payable to an insurance company for the purchase of a deferred variable annuity" subject to principal review requirements under Rule 2330. Securities Exchange Act Release No. 56376 (Sept. 7, 2007).

4. **SEC and FINRA Action in 2015.** In 2015, the SEC and FINRA both addressed subscription-way transactions with regard to mutual fund sales consistent with the variable annuity precedent. *See* SEC Staff No-Action Letter, NYLIFE Securities *LLC* (Mar. 12, 2015) ("NYLIFE Securities") & FINRA Regulatory Notice 15-23 (June 2015) ("Notice 15-23"). Although NYLIFE Securities and Regulatory Notice 15-23 are subject to significant conditions, the relief is important because, previously, such checks were required to be forwarded by noon on the business day after they were received.

B. NYLIFE Securities No-Action Letter

On March 12, 2015, the staff of the SEC Division of Trading and Markets issued a no-action letter to NYLIFE Securities ***extending an order granting exemptions*** under the Exchange Act, originally issued in connection with suitability review and approval of deferred variable annuities, ***to suitability review and approval of mutual funds, Section 529 plans, and other securities issued on a subscription-way basis.*** NYLIFE Securities, *supra* § VII.B.4. Similar to variable annuity suitability review and approval procedures, broker-dealers may now conduct orderly suitability reviews and forward subscription-way checks and applications for mutual fund shares and other securities to the issuer within seven days after receipt by an OSJ.

In its incoming request letter, NYLIFE Securities stated that its sales force sells mutual funds and Section 529 plans, among other products, on a subscription way basis, which are subject to the requirements of FINRA Rule 2111 (the general suitability rule) rather than the VA Suitability Rule. After the customer completes an application for the purchase of shares and makes a check payable to the issuer or another third party, NYLIFE Securities forwards the check and application to

NYLIFE Securities' corporate office for suitability review and sign-off. If the transaction is approved, the check and application are forwarded to the issuer.

In its request letter, NYLIFE Securities noted that the nature of subscription-way sales make it "extremely difficult for NYLIFE [Securities] to meaningfully supervise the sales practices of its representatives, including suitability of customer transactions, and to promptly transmit customer funds to issuers." Moreover, because NYLIFE Securities performs suitability and other sales practice review in a central location, which requires representatives to forward subscription-way applications and customer checks to the central location, it states that it is " impossible for the check to be received and reviewed in that location and then transmitted to the issuer by noon of the day following receipt by the representative."

Based on NYLIFE Securities representations and subject to the below conditions, the staff determined that it would not recommend enforcement action to the Commission if NYLIFE Securities ("***and any other broker-dealer in similar circumstances***") holds customers' checks payable to issuers in order to complete principal suitability review of each sale of a recommended subscription-way security.

In addition to mutual funds and 529 plans, the relief extends to other securities that are subject to FINRA Rule 2111 but not Rule 2330 issued on a subscription-way basis, ***including variable life insurance, immediate variable annuities and other securities.***

In order to rely on the relief granted, broker-dealers must comply with the following conditions:

1. Establish policies and procedures reasonably designed to ensure that each check is safeguarded and that a registered representative of the member who recommends a sale of a security on a subscription-way basis promptly prepares and forwards a complete and correct application package to an OSJ of the member regarding such security;

2. Cause a registered principal to perform a suitability review in accordance with FINRA Rule 2111 and determine whether he or she approves of each recommended subscription-way sale ***within seven business days*** after an OSJ of the member receives a complete and correct application package;

3. Transmit the check no later than noon of the business day following the date the registered principal reviews and determines whether he or she approves the transaction;

4. Maintain a copy of each such check and create a record of the date the check was received from the customer and the date the check was

transmitted to the issuer if approved, or was returned to the customer if rejected; and

5. Disclose to customers its process for handling customer checks payable to issuers for subscription-way securities transactions in advance of each transaction.

C. Regulatory Notice 15-23

On June 19, 2015, FINRA granted similar relief from two FINRA prompt transmittal requirements: (1) FINRA Rule 2150(a), the rule prohibiting broker-dealers from making improper use of customer funds, and (2) NASD Rule 2830(m), the investment company promptly transmit rule.[9] Notice 15-23, *supra* § VII.B.4. Thus, without violating either FINRA Rule 2150(a) or NASD Rule 2830(m), a firm may hold a customer check payable to an issuer for up to seven business days from the date that an OSJ receives a complete and correct application package for the sale of securities on a subscription-way basis.

FINRA's relief from prompt transmittal is subject to the following conditions:

1. "The reason that the firm is holding the application for the securities and a customer's non-negotiated check payable to a third party is to allow completion of principal review of the transaction pursuant to FINRA Rules 2111 and 3110.

2. The associated person who recommended the purchase of the securities makes reasonable efforts to safeguard the check and, after receiving information necessary to prepare a complete and correct application package, promptly prepares and forwards the complete and correct copy of the application package to an OSJ.

3. The firm has policies and procedures in place that are reasonably designed to ensure compliance with condition [2] above.

4. A principal reviews and makes a determination of whether to approve or reject the purchase of the securities in accordance with the provisions of FINRA Rules 2111 and 3110.

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[9] NASD Rule 2830(m)(1) requires firms that engage in *direct retail transactions* for mutual fund shares, to transmit customer payments to payees (i) by end of the third business day following receipt of a customer's order to purchase shares or (ii) by the end of one business day following receipt of a customer's payment for shares, whichever is the later date. Also, Rule 2830(m)(2) requires firms that engage in *wholesale transactions* for fund shares, to transmit payments to fund issuers or their designated agents by the end of two business days following receipt of such payment.

5. The firm holds the application and check no longer than seven business days from the date an OSJ receives a complete and correct copy of the application package.

6. The firm maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the issuer or returned to the customer.

7. The firm creates a record of the date when the OSJ receives a complete and correct copy of the application package."

VIII. IRA ROLLOVERS

A. <u>Background</u>

Unlike the past when employers offered ***defined benefit*** pensions to employees, most employers these days offer ***defined contribution*** plans such as 401(k) plans, which place funding and investment risk directly on plan participants. At the end of first quarter 2015, the ICI reported that (i) total retirement assets amounted to $24.9 trillion, and (ii) Americans held $7.6 trillion in individual retirement accounts ("IRAs"). *See* Investment Company Institute, *Ten Important Facts about IRAs* (July 2015), *available at* www.ici.org/pdf/ten_facts_iras.pdf. ("ICI Ten Important Facts").

The ICI further estimated that, in 2014, about one-third of Americans' retirement savings were held in IRAs and about one-quarter of U.S. households owned traditional IRAs. *See* Sarah Holden and Daniel Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2014," ICI Research Perspective, vol. 21, no. 1 at 1-2, (Jan. 2015), *available at*: www.ici.org/pdf/per21-10.pdf. Rollovers from employer plans – such as 401(k) plans – play an important role in funding IRAs. *Id.* In 2014, households owning 48% of traditional IRAs indicated that their IRAs contained rollovers from employer-sponsored retirement plans and, among these households, 81% indicated that "they had rolled over the entire retirement account balance in their most recent rollover." ICI Ten Important Facts, *supra,* at 8.

The SEC has observed that "Registrants are developing and offering to retail investors a variety of new products and services that were formerly characterized as alternative or institutional, including private funds, illiquid investments, and structured products intended to generate higher yields in a low-interest rate environment." *See* SEC Examination Priorities for 2015 at 2 (Jan. 13, 2015).

B. FINRA Focus

FINRA is focused on firms' controls around the handling of wealth events in investors' lives. Among other events, wealth events include a life insurance payout, a sale of a business or other major asset, a divorce settlement, or an IRA rollover.

1. **<u>2015 Regulatory and Examination Priorities</u>.** In January 2015, FINRA identified IRA rollovers as a regulatory and examination priority. FINRA's focus on IRA rollovers falls into five key areas:

    a. ***Controls*.** FINRA examiners will focus on the controls firms have in place related to wealth events, with an emphasis on firms' compliance with their supervisory, suitability and disclosure obligations.

    b. ***Systems*.** Firms' systems should be reasonably designed to help ensure that financial incentives to the associated person or the firm do not compromise the objectivity of suitability reviews.

    c. ***Retail Communications*.** FINRA has stated that, whether in retail communications or an oral marketing campaign, it would be false and misleading to imply that a retiree's only choice, or only sound choice, is to roll over plan assets to an IRA sponsored by the broker-dealer. Any communications that discuss IRA fees must be fair and balanced, and the firm may not claim that its IRAs are "free" or carry "no fee" when the investor will incur costs related to the account, account investments or both.

    d. ***Written Supervisory Procedures*.** If a firm does not intend for its registered representatives to recommend securities transactions as part of the IRA rollovers of their customers, then the firm should have policies, procedures, controls and training reasonably designed to ensure that no recommendation occurs. Similarly, if registered representatives are authorized to provide educational information only, a firm's written supervisory procedures should be reasonably designed to ensure that recommendations are not made.

    e. ***Oversight*.** Without strong oversight, investors may not obtain the information necessary to make an informed decision, and firms may fail to detect recommendations otherwise prohibited by firm policy.

FINRA 2015 Regulatory and Examination Priorities Letter (Jan. 6, 2015) (emphasis added).

2. **FINRA South Region Compliance Seminar.** On November 20, 2014, a suitability panel at FINRA's South Region Compliance Seminar asked firms a series of questions about reviewing qualified rollovers for suitability:

- "Are firms reviewing qualified rollovers?
- Are the costs of the customer's employer sponsored plan compared with the costs of the proposed IRA rollover transaction?
- Are customers age 55-59½ informed that withdrawals from their IRA will be subject to the 10% early withdrawal penalty?
- Is the customer made aware that they may be able to continue their employer sponsored plan?
- Does the firm properly document the reason for the rollover recommendation, and why the transaction is in the best interest of the customer?"

South Region Compliance Seminar, Tony Cognevich, Examination Manager, FINRA, New Orleans District Office, Moderator (Nov. 20, 2014) *available at* http://www.finra.org/sites/default/files/Suitability.pdf.

3. **2013 Regulatory Notices.** In 2013, FINRA issued two regulatory notices addressing concerns about financial advisers who encourage employees to roll over their qualified plan assets into IRAs without adequate disclosure or suitability analysis. *See* FINRA Regulatory Notice 13-23 (July 2013) (addressing disclosure of fees in communications about IRAs, noting that any discussion of IRA fees must be fair and balanced. For example, a broker-dealer may not claim that its IRAs are "free" or carry "no fee" when the investor will incur costs related to the account, account investments or both) and FINRA Regulatory Notice 13-45 (Dec. 2013) (addressing IRA rollover decision factors and conflicts of interest, noting that "if an associated person receives compensation for the number of IRAs that participants open at his firm, he has an incentive to encourage participants to open IRAs rather than maintain their assets in their plan. . . . Firms must supervise these activities to reasonably ensure that conflicts of interest do not impair the judgment of a registered representative or another associated person about what is in the customer's best interest. . . .").

C. SEC Focus

1. **2015**. In January 2015, the SEC identified "protecting retail investors and investors saving for retirement" as an examination priority, noting that

> "**Sales Practices.** We will assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, especially when they pose greater risks and/or charge higher fees."

See SEC Examination Priorities for 2015 at 2 (Jan. 13, 2015).

2. **2014**. In January 2014, the SEC identified "retirement vehicles and rollovers" as an examination priority. OCIE's examination initiatives included:

- **Sales Practices**. OCIE examines sales practices of investment advisers who target retirement-age workers to roll over their employer-sponsored 401(k) plan into higher cost investments; and

- **Marketing and Advertising.** OCIE examines broker-dealers and investment advisers for possible improper or misleading marketing and advertising, conflicts, suitability, churning, and the use of potentially misleading professional designations.

See SEC Examination Priorities for 2014 at 3 (Jan. 9, 2014).

IX. CONFLICTS OF INTEREST

A. Background

1. **Placing Customer's Interests Before the Firm's Interests**. FINRA Rules impose high ethical obligations on broker-dealers but do not explicitly define conflicts of interest. Fundamentally, FINRA's mantra is to "place the interest of customer first." *See, e.g.,* Remarks of Richard G. Ketchum, FINRA Chairman and Chief Executive Officer, at 2015 FINRA Annual Conference (May 27, 2015). In 2012, FINRA defined conflicts as "business practices [that] put your firm's – or your employee's [sic] – interests ahead of those of your customers." FINRA Targeted Examination Letter (conflicts of interest review) (July 2012).

2. **How Do Conflicts Arise?** Conflicts of interest can arise in any relationship where a duty of care or trust exists between two or more

parties, and, as a result, are widespread across the financial services industry. *See* FINRA 2013 Report on Conflicts of Interest (cited below). While the existence of a conflict does not, *per se*, imply that harm to one party's interests will occur, the history of finance is replete with examples of situations in which financial institutions did not manage conflicts of interest fairly. Many of the foundational pieces of legislation governing financial services in the United States contain provisions crafted precisely to address conflict situations. *See, e.g.*, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, as set forth below.

Statute	Sections Addressing Conflict Situations
Securities Act of 1933	§ 27B (conflicts of interest relating to certain securitizations)
Securities Exchange Act of 1934	§ 15E (registration of nationally recognized statistical rating organizations) Rule 17g-5 (conflicts of interest)
Investment Company Act of 1940	§ 1 (findings and declaration of policy); § 10 (affiliations of directors); § 15 (investment advisory and underwriting contracts); § 17 (transactions of affiliated persons and underwriters); and § 36 (breach of fiduciary duty)
Investment Advisers Act of 1940	§ 205 (investment advisory contracts); § 206 (prohibited transactions by investment advisers); and § 208 (general prohibitions)

B. FINRA's 2013 Report on Conflicts of Interest

1. **General**. Following its sweep in 2012 to review how firms identify and manage conflicts of interest, FINRA issued its "*Report on Conflicts of Interest*" on October 14, 2013, *available at* https://www.finra.org/sites/default/files/industry/p359971.pdf ("2013 Report"). Although the focus of the 2013 Report was solely on broker-dealers regulated by FINRA,[10] the Report also addressed conflicts faced

[10] In this regard, the SEC has noted, "[b]roker-dealers are subject to extensive oversight by the Commission and one or more self-regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO

and handled by dually registered broker-dealer and investment advisory firms.

The 2013 Report summarized FINRA's conflicts of interest analysis in three general areas: (i) enterprise-level conflicts of interest frameworks; (ii) new business and new product conflicts review; and (iii) compensation practices and oversight.

2. **Comprehensive Conflicts Governance Framework.** The first effective practice summarized in the 2013 Report is implementation of "a comprehensive framework to identify and manage conflicts of interest across and within the firms' business lines that is scaled to the size and complexity of their business." The 2013 Report identified the following key features of ***a robust conflicts management framework***:

- a "tone from the top" that emphasizes the importance of ethical treatment of customers and the fair handling of conflicts of interest;
- articulated structures, policies and processes to identify and manage conflicts of interest;
- a willingness to avoid severe conflicts;
- effective disclosure to clients;
- hiring practices that rigorously review potential employees' ethical, financial and regulatory history;
- training that focuses on ethical treatment of customers and enables staff to identify and manage conflicts; and
- an information technology infrastructure that supports conflicts management in a comprehensive manner.

The 2013 Report noted that ***some firms amplify in their written procedures general conflict categories*** with specific examples of conflicts that may arise in their business. Such categories include: firm versus client conflicts; client versus client conflicts; employee versus client conflicts; employee versus firm conflicts; and vendor versus client conflicts.

3. **New Business and New Product Conflicts Review.** For new product launches to be effective, the 2013 Report noted that "identifying and managing conflicts of interest . . . should be a key component of firms' new business planning and implementation efforts." The 2013 Report discussed effective practices to identify and manage conflicts of interest

rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder." *See* Securities Exchange Act Release No. 50980 (Jan. 6, 2005). FINRA rules also impose high ethical obligations on broker-dealers. *See, e.g.*, FINRA Rule 2010 (*Standards of Commercial Honor and Principles of Trade*) and FINRA Rule 2111 (*Suitability*).

that may arise through the launch of a new product or service, including where:

- firms' new product review committees include a mandate to identify and mitigate conflicts of interest that may be associated with the new product;
- firms decline to offer a product where a conflict of interest poses the potential for serious harm to customers and the firm cannot effectively mitigate the conflict;
- firms differentiate product eligibility between institutional and retail clients;
- product manufacturing firms implement strong know-your-distributor ("KYD") policies and processes to assess potential distributors' financial soundness, marketing and sales controls, sales practice and compliance mindset, quality of distribution network and technical capabilities before allowing them to sell a manufacturer's products;
- firms conduct post-launch reviews to assess whether a product has performed as expected;
- firms evaluate registered representatives' ability to understand a product, providing training where it is necessary;
- firms disclose product risks to customers; and
- firms require written attestations that clients understand a product and its risks for certain potentially more complex products.

The 2013 Report addressed "***embedded conflicts***" associated with structured and complex products, where issuer or its affiliates play multiple roles in determining a product's economic outcome and where the economic interests of the issuer (or firm) and investor may diverge. The 2013 Report identified FINRA's concerns with structured products that are linked to a proprietary index (created and maintained by the product issuer).

In addition, the 2013 Report discussed conflicts that arise when a firm favors proprietary products or engages in revenue-sharing with third parties to the detriment of customer interests, including where funds for which a firm receives revenue sharing payments are placed on a "preferred" list of funds the firm offers. The 2013 Report noted that this practice can limit customer choice or may adversely affect the independence of a firm's new product review process or a registered representative's recommendations. The 2013 Report noted, however, that the disclosures it reviewed related to revenue sharing arrangements were "clear and direct."

4. **Compensation and Oversight.** The 2013 Report described financial compensation as a "major source" of conflicts of interest. ***Effective***

compensation and oversight practices identified in the Report include circumstances where:

- firms avoid creating thresholds in their compensation structures that enable a registered representative to increase his/her compensation disproportionately through an incremental increase in sales;
- firms monitor activity of registered representatives approaching compensation thresholds;
- through a "neutral grid," firms minimize incentives in their compensation structure for registered representatives to favor one type of product over another;
- firms cap the gross dealer concession that will be credited to a registered representative's production;
- for comparable products, firms refrain from providing higher compensation or providing other rewards, for the sale of proprietary or products from providers which the firm has entered into revenue-sharing agreements;
- firms monitor the suitability of registered representatives' recommendations around key liquidity events in an investor's lifecycle; and
- using red flag processes and clawbacks, firms adjust compensation for employees who do not properly manage conflicts of interest.

C. <u>2015 Regulatory and Examination Priorities Letter</u>

In announcing its regulatory and examination priorities for 2015, FINRA identified "conflicts of interest" as a factor in many regulatory actions against firms and associated persons. FINRA states:

> "**Conflicts of interest**: Conflicts of interest are a contributing factor to many regulatory actions FINRA (and other regulators) have taken against firms and associated persons. In October 2013, FINRA highlighted effective practices in identifying and managing conflicts of interest. While we have observed positive change since we issued the Report on Conflicts of Interest, FINRA has also recently announced enforcement actions involving firms' failure to adequately address conflicts of interest by offering favorable research in connection with potential investment banking business. We are also reviewing situations where market access customers self-monitor and self-report suspicious trading despite this inherent conflict of interest. And, ***we continue to focus on fee and compensation structures that lie at the heart of many conflicts and which can at times compromise the***

> ***objectivity registered representatives provide to customers***.
> FINRA underscores the importance of firms moving to identify and mitigate conflicts of interest."

FINRA 2015 Regulatory and Examination Priorities Letter (Jan. 6, 2015) (emphasis added).

D. <u>2015 Targeted Examination Letter</u>

In August 2015, FINRA announced its intent to assess "the efforts employed by firms to ***identify, mitigate and manage conflicts of interest***, specifically with respect to ***compensation practices***." *See* Targeted Examination Letter, "Conflicts of Interest Review – Compensation and Oversight" (Aug. 2015) ("2015 Sweep Letter"). The 2015 Sweep Letter seeks extensive information in 19 multi-part questions, is limited to retail accounts, and covers the time period from August 2014 through July 2015. With regard to compensation-related conflicts of interest, the 2015 Sweep Letter seeks information concerning:

- controls utilized to *identify* compensation-related conflicts of interest;
- controls utilized to *manage* compensation-related conflicts of interest;
- surveillance efforts or *supervisory processes* to assess whether compensation-related conflicts of interest are *materializing*;
- how short-term incentives for registered representatives are *balanced* against clients' long-term interests;
- *production thresholds* that entitle any registered representative to higher compensation;
- any *production penalties* in place that can decrease compensation paid to registered representatives;
- the firm's approach to compensating *direct and indirect managers* of registered representatives involved in sales to retail accounts;
- methods used to *display* approved product to registered representatives;
- methods or processes employed to *promote* the sale of specific products;
- the firm's policy for permitting *third-party product or sponsor* representatives to meet with registered representatives;
- policy for permitting registered representatives to attend off-site, overnight educational *sessions sponsored by issuers* or product sponsors;
- top 10 proprietary or *affiliated products* as well as the top 10 *independent products* sold to retail accounts; and
- any flat fee or annual payments received *to make a product available* for sale.

FINRA requested receipt of responses by September 18, 2015. It is not yet clear what FINRA will do with the information submitted in response to the 2015 Sweep Letter. Among other things, it could issue a "best practices" report, initiate further examinations, propose new or amend current compensation rules, or use the information as a basis for enforcement action. By seeking specific information on compensation practices, however, FINRA clearly has made such practices a priority in its current regulatory agenda.

E. **SEC Focus on Conflicts of Interest**

While not identified as an explicit examination priority in its 2015 Examination Priorities Letter, the SEC continues to evaluate conflicts of interest in several areas relevant to distribution of variable products.

1. **Dually Registered Investment Advisers/Broker Dealers.** The SEC has noted that "The convergence among broker-dealer and investment adviser representative activity continues to be a significant risk." SEC Examination Priorities for 2014 at 2 (Jan. 9, 2014). Dual representatives may influence whether a particular customer establishes a brokerage or investment advisory account. "This influence may create a risk that customers are placed in an inappropriate account type that increases revenue to the firm and may not provide a corresponding benefit to the customer." *Id.* at 3.

   When an adviser offers a variety of fee arrangements (*e.g.,* fee based on assets under management, hourly fees, performance-based fees, wrap fees, and unified fees), OCIE's examinations will focus on "recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships." *See* SEC Examination Priorities for 2015 at 2 (Jan. 13, 2015).

2. **Registered Investment Companies.** The SEC Division of Enforcement's Asset Management Unit ("AMU") investigates potential misconduct involving registered investment companies, private funds, and separately managed accounts. On February 26, 2015, Julie M. Riewe, AMU Co-Chief, addressed AMU's focus on conflicts of interest as follows:

   > "Now a few words about one of the [AMU's] overarching concerns across all of the investment vehicles: conflicts of interest. . . . ***In nearly every ongoing matter*** in the [AMU], we are examining, at least in part, whether the adviser in question has discharged its ***fiduciary obligation to identify its conflicts of interest and either (1) eliminate them, or (2) mitigate them and disclose their existence to boards or investors.*** Over and over again we see advisers failing properly to identify and then address their conflicts. . . . Conflicts of interest are material facts that investment advisers, as fiduciaries, must disclose to their clients. . . . There is, therefore, no exception to disclosure. . . ***An adviser's failure to disclose conflicts of interest to clients***

> ***subjects it to possible enforcement action*** . . . On the horizon, we expect to recommend a number of conflicts cases for enforcement action, including matters involving ***best execution failures*** in the share class context, ***undisclosed outside business activities, related-party transactions***, fee and expense misallocation issues in the private fund context, ***and undisclosed bias toward proprietary products and investments***. We also anticipate enforcement action from the Distribution in Guise Initiative, where we are examining, among other things, conflicts presented by registered fund advisers using the fund's assets to grow the fund and, consequently, the adviser's own fee."

See Julie M. Riewe, "Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View" (Feb. 26, 2015) (emphasis added), *available at* http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

X. L-SHARE VARIABLE ANNUITIES

A. Introduction

L-Share variable annuities ("L-Share VAs") are sometimes referred to as "short surrender annuities" because they typically have a ***shorter surrender charge period*** of three to five years. In addition to a short surrender charge period, L-Share VAs have relatively ***higher mortality and expense risk charges*** ("M&E"). By comparison, a typical B-Share variable annuity has a longer surrender charge period of seven years but a lower M&E. Hypothetically, by way of example, if a B-Share VA charges an annual M&E of 1.25%, an L-Share VA might charge an annual M&E of 1.65% (.40% higher).

L-Share VAs offer benefits to contract owners in certain circumstances. For example, a short surrender period would allow a contract owner earlier access (*i.e.*, three or four years) to his or her money without penalty. In turn, access to money through a shorter surrender period would provide flexibility in financial planning strategies or in response to changed circumstances, events or goals.

B. Suitability Concerns

1. **Suitability.** While L-Share VAs offer benefits, the suitability analysis becomes more complicated when the VA is sold with a long-term guaranteed benefit rider. So, in addition to purchasing a rider that is designed for long term investment, a contract owner would be paying, for the long term of the rider, a higher M&E than if he or she had purchased a

share class with a lower M&E. *See* below, § X.C.1. A similar analysis could apply if an L-Share VA is held in an IRA.

2. **Industry Reaction.** As a result of suitability concerns and regulatory concerns discussed immediately below, some firms (i) no longer permit registered representatives to sell L-Share VAs if the variable annuity includes riders or (ii) have asked issuers to redesign the variable annuity to reduce the M&E – to a B-Share level or similar – upon completion of the surrender period. For example, on or about June 22, 2015, Voya determined that affiliated brokers could no longer sell L-Share VAs if the annuity contract includes a rider. *See* "Voya restricts variable-annuity sales under regulatory pressure," *Investment News* (June 23, 2015) *available at* http://www.investmentnews.com/article/20150623/FREE/150629972/voya-restricts-variable-annuity-sales-under-regulatory-pressure.

C. FINRA Reaction to L-Share VAs

1. **South Region Compliance Seminar.** On November, 20, 2014, a suitability panel at FINRA's South Region Compliance Seminar addressed variable annuity share class hypotheticals in a way that compared L-Share VAs with B-Share VAs. *See* South Region Compliance Seminar, Tony Cognevich, Examination Manager, FINRA, New Orleans District Office, Moderator (Nov. 20, 2014) *available at* http://www.finra.org/sites/default/files/Suitability.pdf.

- In a side-by-side comparison chart of B-Shares (with a 7 year surrender period and 1.25% M&E) and L-Shares (with a 3-5 year surrender period and 1.65% M&E), the panel concluded: "Over time, the higher M&E starts to take its toll. If a customer holds on to [the] annuity in excess of the 4 year surrender period, ***the higher fees of the L-share start to eat up any profits***. Significance will depend on how much higher the M&E for the L share is than the B share." *Id.* at page 3, slide 3 (emphasis added).

- The first hypothetical assumed a $100,000 investment and 6% growth rate over 10 years, after sub-account fees (but not including M&E fees), and no withdrawals at the end of 10 years – with a 1.25% B-Share M&E and 1.65% L-Share M&E – and concluded **"Because of the higher M&E fees on the L-Share product, your account value would be $5,970 (3.75%) less than the B-Share product."** *Id.* at page 3, slide 4 (emphasis in original).

- The second hypothetical assumed a withdrawal of $50,000 at the beginning of the fifth year – when there would be no penalty in the L-Share, but a 4% penalty in the B-Share – and concluded "**Subtract the**

$1600 surrender penalty on the B-share product, and you would still be better off by <u>$228</u> than if you bought the L-Share." *Id.* at page 4, slide 6 (emphasis in original).

- In a slide discussing variable annuity suitability share classes, the panel offered the following list of "things to consider":

  "Firms should properly monitor the sale of various VA share classes and ensure that customers are properly informed of the cost/benefit associated with the various classes.

  - Are firms properly ***monitoring the sale*** of L share annuities, especially where the client has indicated a long term time horizon?

  - Are firms ***monitoring the combination*** of L share annuities ***with certain riders*** to ensure that they are compatible with each other?

  - When questions arise, does the firm ***confirm the information with the customer***?

  - Do the firm's [written supervisory procedures] properly discuss the appropriate sale of various ***VA share classes***?

  - Are RRs and reviewing principals ***properly trained***?"

  Id. at page 5, slide 8 (emphasis added).

2. **<u>FINRA 2015 Regulatory and Examination Priority</u>.** With emphasis, FINRA identified sales and marketing of L-Share VAs as a 2015 regulatory and examination priority. *See* FINRA 2015 Regulatory and Examination Priorities Letter at 5 (Jan. 6, 2015) ("FINRA will ***particularly focus*** on the sale and marketing of 'L share" annuities as these shares typically have shorter surrender periods, but higher costs.").

XI. SUPERVISION

A. FINRA 2015 Regulatory and Examination Priority

1. **Supervision, risk management and controls.** In announcing its regulatory and examination priorities for 2015, FINRA identified five "recurring challenges," including the importance of having a system of supervision, risk management and controls. FINRA states:

> "A firm's systems of supervision, risk management and controls are ***essential safeguards to protect and reinforce a firm's culture***. Maintaining the right culture includes having ***robust processes around basic functions such as hiring***. Strong supervisory and risk management systems also prevent inadvertent harm to customers (e.g., a firm failing to provide the proper breakpoint), as well as defend against deliberate acts of malfeasance (e.g., a trader concealing position limit breaches or an executive manipulating accounting balances to make the firm's financial status and results appear stronger than they are). ***Proactive supervisory programs and controls play a crucial role in this effort and many firms have turned to data analytics to help identify problematic behavior.*** One indicator that a firm is succeeding in a proactive approach would be that it has already identified and addressed the concerns FINRA identifies in this letter."

2015 Regulatory and Examination Priorities Letter (Jan. 6, 2015) (emphasis added).

2. **FINRA Supervision Rules.** FINRA's new supervision rules – FINRA Rules 3110, 3120, 3150 and 3170 – became effective on December 1, 2014. The new supervision rule modified requirements relating to:

- "supervising [OSJs] and inspecting non-branch offices;
- managing conflicts of interest in a firm's supervisory system;
- performing risk-based review of correspondence and internal communications;
- carrying out risk-based review of investment banking and securities transactions;
- monitoring for insider trading, conducting internal investigations and reporting related information to FINRA; and
- testing and verifying supervisory control procedures. FINRA regulatory coordinators and examiners will contact and inspect

their assigned firms to address regulatory questions and become familiar with how the firms are implementing the new rule requirements." *Id.*

B. 2015 FINRA Enforcement Actions Involving Lack of Reasonable Supervision

1. Supervision of Mutual Fund Share Classes

Facts. Mutual fund prospectuses disclosed that initial sales charges would be waived on Class A shares for certain types of retirement accounts and charities. Notwithstanding, three large broker-dealers, at various times since July 2009, allegedly did not waive the sales charges for affected customers who purchased Class A shares. As a result, more than 50,000 eligible retirement accounts and charities allegedly either paid sales charges at these firms when purchasing Class A shares, or purchased other share classes that unnecessarily subjected them to higher ongoing fees and expenses.

FINRA Orders. On July 6, 2015, FINRA announced that it ordered the broker-dealers to pay more than $30 million in restitution, including interest, to affected customers for ***failing to waive mutual fund sales charges for certain charitable and retirement accounts***. FINRA ordered the firms to implement training, systems and procedures related to the supervision of mutual fund sales charge waivers. FINRA Letter of Acceptance, Waiver and Consent No. 2015045270901, *LPL Financial LLC* (July 6, 2015); FINRA Letter of Acceptance No. 2015044309501, *Raymond James Financial Services, Inc.* (July 6, 2015); FINRA Letter of Acceptance, Waiver and Consent No. 2015044309001 (July 6, 2015), *Raymond James & Associates, Inc.* (July 6, 2015); and FINRA Letter of Acceptance, Waiver and Consent No. 2014042689901, *Wells Fargo Advisors, LLC* (July 6, 2015).). In concluding these settlements, Wells Fargo, Raymond James, and LPL neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

Takeaway. It is not enough to disclose share class policies in the prospectus. Broker-dealers must adequately supervise sales of mutual funds that offer sales charge waivers to ensure that stated policies are enforced. Also, to the extent broker-dealers rely on their registered representatives to implement sales charge waivers, broker-dealers must provide appropriate information and training.

2. Supervision of Customer Funds

Facts. From 2008 to 2013, three registered representatives from one large broker-dealer allegedly converted customer funds from 13 customer accounts to their personal accounts by creating fraudulent wire transfer orders and branch checks. From 2011 to 2013, another large broker-dealer allegedly did not obtain customer confirmations for third-party transfers.

***FINRA Orders*.** On June 22, 2015, FINRA announced that it fined one firm $650,000 and another firm $300,000 for not implementing reasonable supervisory systems to monitor the transmittal – via wire transfer – of customer funds from customer accounts to third-party accounts and outside entities. FINRA also noted that both firms had been cited in 2011 for the "weak supervisory systems" by FINRA examination teams, "but neither took necessary steps to correct the supervisory gaps." According to FINRA, the "supervisory failures allowed to conversions to go undetected." FINRA Letter of Acceptance, Waiver and Consent No. 2011025479301, *Morgan Stanley Smith Barney* (June 19, 2015) & FINRA Letter of Acceptance, Waiver and Consent No. 2013035000501, *Scottrade, Inc.* (June 19, 2015). In concluding these settlements, Morgan Stanley and Scottrade neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

***Takeaway*.** Broker-dealers should implement and review supervisory systems to review and monitor transmittal of customer funds. Further, if FINRA examination staff identifies supervisory weaknesses, broker-dealers should take steps to correct identified weakness before the next exam.

3. Supervision of Complex Products and Trade Confirmations

Facts. At various times spanning multiple years, a broker-dealer allegedly did not supervise sales of variable annuities, exchange traded funds ("ETFs") and non-traded real estate investment trusts ("REITs"). The lack of reasonable supervision in these areas allegedly resulted in the broker-dealer:

- permitting ***variable annuity sales*** without disclosing surrender fees;
- using an automated surveillance system that excluded mutual fund "switch" trades from supervisory review;
- lacking a system to monitor the length of time that customers held non-traditional ETF securities in their accounts;
- not enforcing its limits on the concentration of non-traditional ETFs in customer accounts, and not ensuring that all of its registered representatives were adequately trained on the risks of the non-traditional ETFs;
- not identifying accounts eligible for volume sales charge discounts in non-traded REIT products; and

- not monitoring the creation or use of consolidated reports or ensuring that these reports reflected complete and accurate information.

Further, FINRA found that the broker-dealer's ***systems to review trading activity in customer accounts*** were deficient. The flawed systems and lack of reasonable supervision resulted in the broker-dealer:

- using a surveillance system that did not generate alerts for certain high-risk activity, including low-priced equity transactions, actively traded securities and potential employee front-running;
- using an automated system to review its trade blotter that did not provide trading activity past due for supervisory review;
- not delivering over 14 million confirmations for trades in 67,000 customer accounts;
- using an anti-money laundering surveillance system that did not generate alerts for excessive ATM withdrawals and ATM withdrawals in foreign jurisdictions;
- not reporting certain trades to FINRA and the MSRB; and
- not ensuring it provided complete and accurate information to FINRA and to federal and state regulators concerning certain variable annuity transactions.

<u>FINRA Order</u>. On May 6, 2015, FINRA announced that it censured the broker-dealer and fined it $10 million for "broad supervisory failures" in the above areas and other complex products. FINRA also ordered the broker-dealer to pay approximately $1.7 million in restitution to certain customers who purchased non-traditional ETFs. FINRA Letter of Acceptance, Waiver and Consent No. 2013035109701, *LPL Financial LLC* (May 6, 2015). In settling this matter, LPL neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

<u>Takeaway</u>. It is not enough to design a supervisory system to address human actions. Broker-dealers must reasonably supervise their surveillance and other automated systems in addition to the associated persons responsible for those systems.

4. <u>Supervision of Consolidated Reports</u>

<u>Facts</u>. Consolidated reports combine information regarding most all of a customer's financial holdings regardless of where assets are held. In the course of routine examinations, FINRA discovered that numerous registered representatives of three broker-dealers prepared and disseminated consolidated reports to customers either without adequate review or any prior review by a principal. FINRA also found that two of the broker-dealers did not have any written procedures specifically addressing the use and supervision of consolidated reports and a third broker-dealer had written procedures related to consolidated reports, but did not enforce the procedures or provide proper training to its registered representatives regarding their use. Further, registered representatives utilized consolidated report systems that allowed them to enter customized values for accounts or investments held away from the broker-dealer, but the broker-dealer's procedures did not provide safeguards, such as requiring supporting data, to verify accuracy.

FINRA Orders. On March 30, 2015, FINRA announced that it sanctioned three broker-dealers and imposed fines for inadequate supervision of consolidated reports provided to customers. FINRA Letter of Acceptance, Waiver and Consent No. 2012031552601, *H. Beck, Inc.* (Mar. 30, 2015); FINRA Letter of Acceptance, Waiver and Consent No. 2013035055101, *LaSalle St. Securities LLC* (Nov. 10, 2014); and FINRA Letter of Acceptance, Waiver and Consent No. 2013036404301, *J.P. Turner & Company LLC* (Mar. 27, 2015). In concluding these settlements, H. Beck, Inc., LaSalle St. Securities and J.P. Turner neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

Takeaway. Consistent with FINRA's guidance in Regulatory Notice 10-19 (April 2010), if broker-dealers use consolidated reports, the reports must be clear, accurate and not misleading. Further, related supervision must be rigorous to ensure that the information contained therein is not inaccurate, confusing or misleading. If a broker-dealer is unable to adequately supervise the use of consolidated reports, it must prohibit their dissemination.

5. Supervision of Registered Representative with a Checkered Past

Facts. Broker-dealer allegedly failed to supervise one of its registered representatives by:

- not ***investigating the candidate prior to hiring him***, even though he was subject to 12 reportable events, including criminal charges and seven customer complaints;
- not placing the registered representative under ***heightened supervision*** despite learning that the registered representative's business partners had recently sued him for defrauding them out of millions of dollars;
- not ***responding to "red flags"*** in correspondence and wire transfer requests when the registered representative was wiring funds from the customer accounts (more than $2.9 million) to entities that he owned or controlled;

- not adequately supervising the registered representative's customers' accounts even though the broker-dealer's surveillance analysts detected excessive trading; and
- not making more than 300 required filings, on a timely basis, to FINRA about some of its registered representatives, so the investing public was not timely made aware of serious allegations made against the broker-dealer's registered representatives.

<u>FINRA Order</u>. On March 26, 2015, FINRA announced that it fined a broker-dealer $2.5 million and ordered it pay restitution of $1.25 million to 22 customers for failing to supervise a former registered representative who stole money from his customers and excessively traded their brokerage accounts. (The broker-dealer had already paid more than $6 million to resolve related customer arbitration claims.) FINRA Letter of Acceptance, Waiver and Consent No. 2009017408102, *Oppenheimer & Co. Inc.* (Mar. 26, 2015). In settling this matter, Oppenheimer neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

<u>Takeaway</u>. Don't overlook the obvious: broker-dealers should design and enforce rigorous registered representative intake procedures that include vetting the candidate's disciplinary history, financial history, and personal history. If necessary, place registered representatives under heightened supervision and follow up. Don't ignore red flags. Make timely filings.

C. <u>Recidivist Reps – SEC's OCIE Use of Data Analytics</u>

For its part, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced in January 2015 that over the last several years it has made "significant enhancements" in its analytic capabilities. As relevant to supervision of registered persons, OCIE said it would use data analytics to identify ***recidivist representatives***, *i.e.,* "individuals with a track record of misconduct and examine the firms that employ them." *See* SEC Examination Priorities for 2015 at 4 (Jan. 13, 2015).

XII. SENIOR INVESTORS

A. <u>OCIE/FINRA National Senior Investor Initiative</u>

1. **<u>Report</u>.** On April 15, 2015, the SEC and FINRA released their joint report on the National Senior Investor Initiative. *See* National Senior Investor Initiative (Apr. 15, 2015), *available at* http://www.finra.org/file/sec-national-senior-investor-initiative ("National Senior Investor Report" or "report"). The report refers to "***senior investors" as investors 65 years old or older***. It includes observations and

notable practices gathered from ***examinations of 44 broker-dealers,*** by OCIE in coordination with FINRA, focused on (i) the types of securities senior investors were purchasing and (ii) the methods firms were using when recommending securities. *Id.* The report also addresses recent industry trends that have impacted the investment landscape and prior regulatory initiatives that have concentrated on senior investors and industry practices related to senior investors. *Id.* The report concludes that "OCIE and FINRA staff are concerned that broker-dealers may be recommending unsuitable securities to senior investors or failing to adequately disclose the related risks." *Id.* at 32.

2. **<u>Report Findings – Securities Purchased</u>.** The staff asked firms to provide a list of the top revenue-generating securities purchased by their senior investors by dollar amount. The staff concluded that mutual funds, variable annuities, and equities are most often purchased by senior investors. The following illustrates the different types of securities purchased by senior investors and percentage of firms offering those securities to senior investors:

Types of Securities Offered to Senior Investors	Firms Offering These Securities to Senior Investors
Open-End Mutual Funds	77%
Variable Annuities	68%
Equities	66%
Fixed Income Investments	25%
UITs and ETFs	20%
Non-Traded REITs	almost 20%
Alternative Investments (options, BDCs, leveraged inverse ETFs)	15%
Structured Products	11%

Source: National Senior Investor Report at 6.

3. **<u>Report Findings – Notable Practices</u>.** The staff reviewed and considered how firms were (i) training their registered representatives and supervisors on issues relating to aging, (ii) using senior designations, (iii) marketing themselves to seniors, (iv) collecting and documenting information from seniors on their financial condition, risk tolerance and investment objective, (v) reviewing whether recommendations of securities were suitable for seniors, (vi) providing disclosures to seniors, (vii) handling customer complaints, and (vii) supervising their registered representatives dealing with seniors. The following summarizes notable practices of firms identified in the National Senior Investor Report.

Issue Considered by OCIE	**Notable Practices of Firms**
Training	Requiring mandatory training classes over a 12-month period. The classes covered the stages of mental capacity (full or diminished) and solutions to handling an investors potential diminished mental capacity. Training of supervisory staff to assist personnel in handling an investor's potential diminished capacity and elder financial abuse concerns.
Use of Senior Designations	Requiring senior designations to have a verified curriculum, a continuing education element, and accreditation from a recognized independent institution. Requiring supervisory approval prior to use of senior designations. Prohibiting the use of senior designations.
Marketing and Communications	Having written supervisory procedures that require supervisory approval to participate in unscripted seminars and other forms of public appearances that are not subject to the principal pre-use approval requirement. Distributing evaluation forms to seminar attendees to solicit feedback, which forms are then received by a supervisor to identify any issue of concern that may violate firm policies or FINRA content requirements.
Account Documentation	Obtaining more detailed customer account information than what is required by applicable rules (*e.g.,* obtain detailed expense information and calculate both short and intermediate-term expenses)

Issue Considered by OCIE	Notable Practices of Firms
	Using automated supervisory alerts to ensure that updated customer investment profiles accurately reflect changes in customers' personal and financial circumstances.
Suitability	Adopting policies and procedures addressing risks specific to senior investors. Requiring representatives to memorialize in firm computer systems conversations with senior investors relating to the recommendations. Drafting product applications that require firm representatives to consider and document crucial investment profile information. Establishing strict firm product concentration guidelines for senior investors
Disclosures	Requiring a customer signature on a disclosure form indicating that the customer received a prospectus when purchasing new open-end mutual funds. Requiring an explanation of the tax ramifications and alternative investment possibilities for all customer who purchase a variable annuity in an IRA. Providing a detailed description of registered representative compensation (both direct and indirect) for each product sold on their website. Providing one comprehensive disclosure form that includes simple definitions for industry nomenclature and the schedule of fees and expenses related to specific securities.
Customer Complaints	Coding complaints as "senior related" in internal systems to enhance a firm's ability to more appropriately respond to senior investors and analyze complaint data.

Issue Considered by OCIE	Notable Practices of Firms
Supervision	Establishing firm policies that address FINRA Regulatory Notice 07-43, which discusses enhanced suitability practices, communications, dealing with investors suffering from diminished capacity, and occurrences of suspected financial abuse. Maintaining product suitability guidelines for senior investors purchasing complex or alternative products such as variable annuities, equity-indexed annuities, REITs, and options. Using a centralized supervisory review group to approve transactions and new accounts. Using automated systems and tools that are integrated with the firm's supervisory review system and compliance departments.

Source: National Senior Investor Report at 8-31.

B. FINRA 2015 Regulatory and Examination Priorities Letter

1. **Background.** In identifying "senior investors" as one of its 2015 regulatory and examination priorities, FINRA provided the following background: "The population of senior investors is large and growing; between 2012 and 2020, the number of Americans aged 65 or greater is projected to increase from 43 million to 56 million, and to 73 million by 2030. The ***consequences of unsuitable investment advice*** can be particularly severe for this investor group since they rarely can replenish investment portfolios with fresh funds and lack time to make up losses."

2. **FINRA Examination Findings**. FINRA completed an examination initiative on senior issues. Based on that examination, FINRA determined that, "many firms are increasingly proactive in dealing with senior investors by developing ***specific internal guidelines to strengthen suitability decisions and providing training*** on the needs of these investors, including, in some cases handling individuals experiencing diminished capacity or elder abuse." *Id.*

3. **FINRA Review of Communications, Suitability, and Training.** FINRA announced that its examiners will continue "to review communications

with seniors; the suitability of investment recommendations made to seniors . . . ; the training of registered representatives to handle senior-specific issues; and the supervision firms have in place to protect seniors." FINRA cautioned that "firms that conduct seminars directed to senior investors must ensure that the presentations are fair, balanced and not misleading." *Id.*

C. FINRA Rulemaking

On September 17, 2015, FINRA announced that its Board of Governors approved a rulemaking item "to help firms better protect ***seniors and other vulnerable adults*** from financial exploitation." The proposal would:

- apply to investors (i) age 65 or older or (ii) age 18 or older if they have mental or physical impairments that render them unable to protect their own interests and there is a reasonable belief of exploitation;

- amend FINRA's ***customer account information rule*** to require firms to make reasonable efforts to obtain the name and contact information for a trusted contact person upon opening a customer's account;

- create a new FINRA rule to allow firms to ***place a temporary hold on a disbursement of funds or securities***, from the accounts of investors aged 65 or older where there is a reasonable belief that financial exploitation may have occurred; and

- not require such temporary holds on disbursements, but would provide firms with a safe harbor when they exercise discretion in placing temporary holds on disbursements.

See FINRA News Release "FINRA Board Approves Rulemaking Item to Protect Seniors and other Vulnerable Adults from Financial Exploitation," (Sept. 17, 2015), *available at* http://www.finra.org/newsroom/2015/finra-board-approves-rule-protecting-seniors-financial-exploitation.

The News Release notes that FINRA plans to issue a Regulatory Notice "in the next several weeks" soliciting comment on the proposal. As of the date of this outline, FINRA had not issued a Regulatory Notice. It is not clear what FINRA considers a "***temporary hold***" and whether this hold would be consistent with, among other things, Section 22(e) of the Investment Company Act of 1940, requiring payment or satisfaction upon redemption of any redeemable security ***within seven days*** unless an exception applies.

XIII. FINRA BEST INTEREST STANDARD

A. Background

Scholarly articles and entire outlines have been written on fiduciary duty, best interest, harmonization of standards and the like.[11] An analysis of this important topic, as well as the Department of Labor's 2015 fiduciary proposal, is beyond the scope of this outline. Nevertheless, consistent with the subject of this outline, below is a summary of key 2015 FINRA statements on the issue.

B. Views of FINRA's Chairman and Chief Executive Officer

In remarks from the 2015 FINRA Annual Conference, Richard Ketchum, FINRA chairman and chief executive officer, discussed the important question of the ***appropriate standard of care for broker-dealers***. Ketchum advocated that the time has come "to require broker-dealers, when recommending a security or strategy to retail investors, to ensure that the recommendation is in the 'best interest' of the investor." Richard G. Ketchum, Remarks from the 2015 FINRA Annual Conference (May 27, 2015). Ketchum explained why "the current Labor proposal is not the appropriate way" to meet the goal of achieving a best interest or fiduciary standard and that "the SEC is the right agency to apply a 'best interest' standard to broker-dealers."

Ketchum suggested the following as ***elements of a best interest standard***:

- the best interest standard should make clear that the ***customer interests come first*** and that any remaining conflicts must be knowingly consented to by the customer.
- Any such proposal should include a requirement that financial firms establish carefully designed and articulated structures to ***manage conflicts of interest*** that arise in their businesses.
- Any best interest standard should also begin by applying ***know-your-customer and suitability standards*** as "belt and suspenders" backstops, similar to what is contained in FINRA's rules.

[11] *See, e.g.,* James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. L. 1 (Nov. 2012); Carl B. Wilkerson, *The SEC's Continuing Quest for a Harmonized Standard of Care Governing Broker-Dealers and Investment Advisers*, 2013 ALI-CLE CONFERENCE ON LIFE INSURANCE COMPANY PRODUCTS at 825 (Nov. 13-15, 2013) (reviewing and addressing "the latest chapter in the long-running and continually evolving debate over the appropriate standard of care for broker-dealers and investment advisers under the federal securities laws").

- There should be more ***effective disclosure*** provided to investors. Broker-dealers should be required to provide customers with an ADV-like document annually that provides clear, plain English descriptions of the conflicts they may have and an explanation of all product and administrative fees.

- Firms should take concrete steps to address the incentives for their registered persons from differential product compensation.

C. FINRA Comments on DOL Fiduciary Proposal

On August 10, 2015, the United States Department of Labor ("DOL") held a four-day public hearing to address its re-proposed rule to create a new fiduciary standard ("DOL Fiduciary Proposal"). *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice; Proposed Rule, 80 Fed. Reg. 21928 (April 20, 2015). Prior to the hearings, FINRA submitted comments on the DOL proposal. *See* Letter to Department of Labor from Marcia E. Asquith, Senior Vice President and Corporate Secretary (FINRA) on Proposed Conflict of Interest Rule and Related Proposals, RIN-1210-AB32 (July 17, 2015) ("FINRA Comment Letter"). FINRA supports a "best interest" standard for broker-dealers.

1. **Minimum Criteria for a Best Interest Standard.** FINRA commented that, at a minimum, any best interest standard should require financial institutions and their advisers to:

   - act in their customers' best interest;

   - adopt procedures reasonably designed to detect potential conflicts;

   - eliminate those conflicts of interest whenever possible;

   - adopt written supervisory procedures reasonably designed to ensure that any remaining conflicts, such as differential compensation, do not encourage financial advisers to provide any service or recommend any product that is not in the customer's best interest;

   - obtain retail customer consent to any conflict of interest related to recommendations or services provided; and

   - provide retail customers with disclosure in plain English concerning recommendations and services provided, the products offered and all related fees and expenses. *Id.*

2. **<u>Benefits of a Best Interest Standard</u>.** Throughout its comment letter, FINRA noted the benefits of a best interest standard, including the following:

- A best interest standard would help create a set of consistent responsibilities for financial service professionals and help to better "align the interests of intermediaries with those of their customers." *Id.* at 2.

- A best interest standard should apply to both retirement and non-retirement accounts. *Id.* at 3.

- "To be successful, the standard must ***build upon existing principles under the federal securities laws*** rather than introducing precepts without precedent that will impede the good faith efforts of financial institutions and advisers to comply." *Id.*

3. **<u>FINRA Recommendations to Improve DOL Fiduciary Proposal</u>.** FINRA recommended five fundamental improvements to the DOL Fiduciary Proposal. Namely, FINRA said the DOL Fiduciary Proposal *should:*

- "clarify the scope and meaning of the best interest standard." *Id.* at 5. There would be significant litigation risks if professionals were required to "to recommend the 'best' product . . ." *See id.* at 7.

- streamline the "treatment of differential compensation," by allowing financial institutions to "either adopt stringent procedures that address the conflicts of interest arising from differential compensation, or pay only neutral compensation to advisers." *Id* at 5.

- "be based on existing principles in the federal securities laws and FINRA rules. In doing so, the Department would help remove many of the ambiguities that will frustrate good faith attempts at compliance, would avoid conflict with existing rules, and would better ensure that the Proposal's objectives are achieved. FINRA stands ready to engage in additional rulemaking to enhance present requirements." *Id.* For example, FINRA observed that certain definitions, such as the definition of "recommendation," have been subject to years of interpretation that is now used within the industry. *See id.* at 12.

- "streamline the BICE and Principal Transaction Exemption (together, the 'Prohibited Transaction Exemptions' or 'PTEs') so that they only impose conditions that restrict conflicts of interest, and eliminate the ambiguous conditions that will not meaningfully address those conflicts." *Id.* at 5.

- "clarify the effects of non-compliance with the Prohibited Transaction Exemptions and the extent that remedies can be defined in the BICE contract." *Id.*

XIV. REGISTERED REPRESENTATIVE RECRUITMENT PRACTICES

A. Background

FINRA is concerned that retail customers may not be aware of important factors to consider in making an informed decision whether to transfer assets to their transferring registered representative's new firm.

B. Initial Proposal – March 2014

In March 2014, FINRA released its initial proposal addressing registered representative recruitment practices. *See* Securities Exchange Act Release No. 71786 (Mar. 24, 2014). The March 2014 proposal included two components:

1. **Disclosure Obligation**. The initial proposal imposed a disclosure obligation on recruiting firms to former retail customers[12] who the recruiting firm attempts to induce to follow a transferring registered representative. The disclosure obligation would have required a member recruiting firm to disclose to former customers ranges of recruitment compensation that the representative has received or will receive in connection with moving firms and the basis for that compensation (*e.g.,* asset-based or production-based). In addition, the initial proposal would have required disclosure if a former customer would incur costs to transfer assets to the member firm that would not be reimbursed by the member firm and if any of the former customer's assets were not transferrable to the recruiting firm. The initial proposal would have required disclosure for one year following the date the registered representative began employment or associated with the recruiting firm.

2. **Reporting Obligation**. The initial proposal also imposed a reporting obligation to FINRA when a transferring representative receives a significant increase in compensation.

[12] The initial proposed rule would have defined the term "former customer" to mean any customer who had a securities account assigned to a registered person at the registered person's previous firm. The term does not include an account of a non-natural person that meets the definition of an institutional account pursuant to FINRA Rule 4512(c). FINRA Rule 4512(c) defines institutional account to mean the account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

Commenters on the initial proposal conveyed concerns about the proposal's competitive implications and operational aspects, as well as the effectiveness of the proposed compensation disclosures.[13] In June 2014, FINRA withdrew the initial proposal to further consider the comments. *See* Securities Exchange Act Release No. 72459 (June 24, 2014).

C. **Proposed FINRA Rule 2272**[14]

1. **Educational Communication.** After considering comments received in response to the initial proposal filed with the SEC in March 2014, on May 27, 2015, FINRA proposed Rule 2272, which would require a member firm that hires or associates with a registered representative ("recruiting firm") to provide an educational communication to former retail customers who the member, directly or through the transferring representative, attempts to induce to transfer assets to the recruiting firm or who choose to transfer assets to the recruiting firm. *See* FINRA Regulatory Notice 15-19 (May 2015). (The proposed rule text is available as Attachment A and the proposed educational communication is available as Attachment B to this notice.)

    - The educational communication is intended to prompt a former customer to make further inquiries of the transferring representative (and, if necessary, the customer's current firm), to the extent that the customer considers the information important to his or her decision-making.

    - The educational communication would highlight the potential implications of transferring assets to the recruiting firm and suggest questions a customer may want to ask to make an informed decision.

    - The recruiting firm would be required to provide the educational communication at or shortly after the time of first contact with a former retail customer regarding the transfer of assets to the recruiting firm.

2. **No Reporting Obligation.** The proposed rule does not include the reporting obligation to FINRA that was in the initial proposal.

[13] Comments on the initial proposal are *available at* http://www.sec.gov/comments/sr-finra-2014-010/finra2014010.shtml.

[14] FINRA Rule 2272 is the same rule number used for the recently adopted rule governing sales on military installations. *See supra* §VI.

3. **<u>Content of Educational Communication</u>.** The educational communication would highlight the potential implications of transferring assets to the recruiting firm and suggest questions the customer may want to ask to make an informed decision regarding:

- Whether the financial incentives received by the representative may create a conflict of interest;
- Assets that may not be directly transferrable to the recruiting firm and as a result the customer may incur costs to liquidate and move those assets or inactivity fees to leave them with his or her current firm;
- Potential costs related to transferring assets to the recruiting firm, including differences in the pricing structure and fees imposed between the customer's current firm and the recruiting firm; and
- Differences in products and services between the customer's current firm and the recruiting firm.

4. **<u>Industry Comment</u>.**[15]

The National Association of Insurance and Financial Advisors ("NAIFA") raised the following concerns in its public comment letter regarding FINRA's proposed rule:

(i) FINRA should consider streamlining and reducing the lengths and contents of the proposed education material to increase the likelihood that consumers will read and act upon the information in the document;

(ii) in requiring customers to affirm receipt of the educational materials, the rule should not impose on either the firm or the representative unreasonable duties to ensure affirmation. Further, the rule should expressly state that failure to obtain an affirmation of receipt does not create an implication that the educational communication was not provided;

(iii) concern that discussion of compensation and conflicts of interest will cause investors to focus on these issues rather than other relevant matters such as the net costs to the investor of working with one broker-dealer versus another and the relative advantages of one firm over another with respect to the platform, products, and services offered; and

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[15] The letters cited herein and other comment letters regarding FINRA Regulatory Notice 15-19 are *available at:* https://www.finra.org/industry/notices/15-19.

(iv) the scope of the rule should not be expanded to apply beyond former retail customers of the representative who changes firms.

SIFMA raised the following concerns in its public comment letter regarding FINRA's proposed rule:

(i) FINRA should address various operational challenges to better align the rule's direct and indirect costs with its stated goals. Specifically, FINRA should:

- include a uniform delivery obligation in the rule and should tie the delivery of the Educational Communication to existing processes;
- remove the "attempt to induce"/"inducement" concept from the rule; and
- apply the delivery obligation for 90 days to maximize effectiveness.

(ii) the proposal should include exceptions for de minimis recruitment compensation and non-recruiting contexts. The rule's supplementary material should include exceptions to properly narrow the scope of the delivery obligation to contexts in which recruitment compensation serves as a significant motivating factor for a registered person to change firms;

(iii) FINRA should permit firms to alter the focus of the educational communication in appropriate contexts. Financial incentives for representatives changing firms appear to be the primary focus of the educational communication. In contexts where such financial incentives are not present the educational communication may confuse or mislead former customers. Under these circumstances, firms should be permitted to alter the discussion topics contained in educational communication to exclude topics that are not relevant to a particular case; and

(iv) FINRA should replace the use of "broker" in the educational communication with a term more commonly used in the industry, such as "registered representative," "registered person," or "financial advisor."

XV. CONTINUING EDUCATION

A. Background

FINRA Rule 1250 prescribes requirements regarding the continuing education of registered persons subsequent to initial qualification and registration. The rule consists of a Regulatory Element and a Firm Element. In 2015, the SEC approved amendments to FINRA Rule 1250 to provide a ***web-based delivery method for completing the Regulatory Element***. *See* Securities Exchange Act Release No. 75581 (July 31, 2015).

B. Regulatory Element Requirements

FINRA determines the content of the Regulatory Element. The Regulatory Element generally consists of training on regulatory, compliance, ethical and supervisory subjects, and sales practice standards. Registered persons must complete the Regulatory Element on their second registration anniversary and every three years thereafter. Unless otherwise determined by FINRA, a registered person's registration will be deemed inactive if he or she does not complete the Regulatory Element within the prescribed time frames; a registration that is inactive for two years will be administratively terminated. *See* FINRA Rule 1250(a)(2). Currently the Regulatory Element is administered in a test center or in-firm subject to satisfaction of specified procedures, including a letter of attestation for in-firm delivery. Currently, "most registered persons complete the Regulatory Element in a test center." FINRA Regulatory Notice 15-28 (Aug. 2015).

C. Web-Based Delivery of Regulatory Element – CE Online

1. **Reason for Change.** Due to costs and other concerns regarding the test center delivery method, FINRA proposed, and the SEC approved, amendments to Rule 1250(a)(6) to permit FINRA to administer the Regulatory Element program through a web-based delivery method called "CE Online." *Id.* CE Online will allow for greater flexibility for registered persons who may now complete the Regulatory Element without visiting a designated testing location.

2. **Effective Dates.** The roll-out will be in two phases. The first phase launch was October 1, 2015, for Series 6 investment company and variable contracts representatives (S106), registered supervisors/principals (S201), and Series 99 operations professionals (S901). The second phase launch is January 4, 2016, for all other categories (S101). FINRA intends to phase out test-center delivery no later than July 4, 2016 (*i.e.,* six months after January 4, 2016).

3. **Takeaway.** Firms should update their written supervisory procedures concerning CE Online and communicate the update to their registered persons. In this regard, FINRA will permit firms to impose their own conditions based on their supervisory and compliance needs. *Id.* at note 7. If a firm's registered persons hold Series 7 registrations (or other non-Series 6, non-supervisor/principal registrations, or non-Series 99 registrations), the firm should plan for the two phase implementation for those individuals.

XVI. CYBERSECURITY DEVELOPMENTS

Much has been written about cybersecurity and regulatory developments in this important area. Below is a brief chronological list of key 2015 SEC and FINRA cybersecurity regulatory and enforcement developments.

A. SEC Focus on Cybersecurity

1. **SEC Examination Priorities for 2015.** On January 13, 2015, the SEC identified cybersecurity as a 2015 examination priority, noting as follows:

> "**Cybersecurity**. Last year, we launched an initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls. In 2015, we will continue these efforts and will expand them to include transfer agents."

See SEC Examination Priorities for 2015 at 3 (Jan. 13, 2015).

2. **OCIE Cybersecurity Sweep Examination Summary.** On February 3, 2015, OCIE's National Examination Program issued a Risk Alert addressing its cybersecurity sweep examination, announced in April 2014, of 57 broker-dealers and 49 investment advisers, *available at* www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

3. **SEC IM Guidance Update.** In April 2015, the SEC Division of Investment Management ("IM") issued online cybersecurity guidance for funds and advisers. *See* IM Guidance Update No. 2015-2 (Apr. 2015), *available at* www.sec.gov/investment/im-guidance-2015-02.pdf. IM's guidance identifies measures that funds and advisers may wish to consider when addressing cybersecurity risk.

4. **OCIE 2015 Cybersecurity Examination Initiative.** On September 15, 2015, OCIE's issued a risk alert addressing OCIE's 2015 examination initiative, *available at* www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf. This risk alert provides

additional information on the areas of focus for OCIE's second round of broker-dealer and investment adviser cybersecurity examinations. Among other things, OCIE intends to test implementation of broker-dealer and investment adviser cybersecurity procedures.

5. **SEC Enforcement Action.** On September 22, 2015, the SEC announced an action against an investment adviser involving alleged failure to establish required cybersecurity policies procedures in advance of a breach that "compromised the personally identifiable information (PII) of approximately 100,000 individuals, including thousands of the firm's clients." The SEC Complaint alleged that the adviser violated Section 30(a) of Regulation S-P, which requires investment advisers to adopt policies and procedures reasonably designed to protect customer records and information. *See In the matter of R.T. Jones Capital Equities Management, Inc.,* Investment Advisers Act Release No. 4204, File No. 3-16827 (Sept. 22, 2015). Without admitting or denying the findings, R.T. Jones agreed to (i) cease and desist from committing or causing any future violations of Rule 30(a) of Regulation S-P and (ii) be censured and pay a $75,000 penalty.

6. **SEC Investor Alert on Cybersecurity.** Also on September 22, 2015, the SEC's Office of Investor Education and Advocacy issued an Investor Alert entitled "*Identity Theft, Data Breaches and Your Investment Accounts*" (Sept. 22, 2015) ("SEC Alert"), *available at* http://www.investor.gov/news-alerts/investor-alerts/investor-alert-identity-theft-data-breaches-your-investment-accounts. The SEC Alert identifies steps investors can take regarding their investment accounts if they become victims of identity theft or a data breach that compromises their personal financial information.

B. FINRA Focus on Cybersecurity

1. **2015 Regulatory and Examination Priorities Letter.** On January 6, 2015, FINRA identified cybersecurity as a 2015 regulatory and examination priority. In its letter, FINRA noted that a cybersecurity attack could create a books and records issue by impacting a firm's compliance with Exchange Act Rule 17a-4(f), which governs electronic storage of records required to be maintained, noting, with emphasis added:

> "FINRA observes that recent events have highlighted the potential adverse consequences of cyber attacks that destroy data. In accordance with [Exchange Act] Rule 17a-4(f), firms are permitted to ***store records electronically***, provided that the media "(***p)reserve the records exclusively in a non-rewriteable, non-erasable format***." In a 2003 Interpretation to [Exchange Act] Rule 17a-4, the SEC noted

that the rule does not specify the type of storage technology that may be used, but rather sets forth standards that the electronic storage media must meet to be considered an acceptable method of storage. [*See* Exchange Act Release No 47806.] In its 2003 interpretation, the SEC clarified that firms may use integrated hardware and software control codes to store data, ***provided "the electronic storage system . . . prevents the overwriting, erasing or otherwise altering of a record during its required retention period. . . ."*** Given the widespread use of electronic storage media for record storage and the fundamental importance of firms' books and records to their ability to conduct business, a cyber attack that permanently destroys data may severely impact a firm's ability to continue operating. ***In 2015, FINRA examiners will review firms' approaches to ensuring compliance with Rule 17a-4(f) in the event of a cyber attack.***

2. **FINRA Report on Cybersecurity Practices.** On February 3, 2015, FINRA issued a *Report on Cybersecurity Practices* ("FINRA Report"), *available at* http://www.finra.org/newsroom/2015/finra-issues-report-cybersecurity-practices-cybersecurity-investor-alert. In releasing the report, FINRA noted "Broker-dealers are ***increasingly exposed to cybersecurity risks***, and breaches at a broker-dealer could entail adverse implications for investors, firms, capital markets and even broader swaths of the financial system."

   The FINRA Report followed FINRA's January 2014 cybersecurity sweep and a 2011 survey of firms. The 2014 sweep focused on the types of threats firms face, areas of vulnerabilities in their systems and firms' approaches to managing these threats. *See* http://www.finra.org/industry/cybersecurity-targeted-exam-letter. According to the FINRA Report, the focus is "on select topics that serve as a resource for firms developing or advancing their cybersecurity programs:

   - cybersecurity governance and risk management;
   - cybersecurity risk assessment;
   - technical controls;
   - incident response planning;
   - vendor management;
   - staff training;
   - cyber intelligence and information sharing; and
   - cyber insurance."

With regard to cybersecurity risk assessment, for example, the FINRA Report encouraged firms to conduct cybersecurity risk assessments as follows:

> "Firms should ***conduct regular assessments to identify cybersecurity risks*** associated with firm assets and vendors and prioritize their remediation. Effective practices include establishing and implementing governance frameworks to:
>
> - identify and maintain an inventory of assets authorized to access the firm's network and, as a subset thereof, critical assets that should be accorded prioritized protection; and
> - conduct comprehensive risk assessments that include:
>   - an assessment of external and internal threats and asset vulnerabilities; and
>   - prioritized and time –bound recommendations to remediate identified risks."

FINRA Report at 12 (emphasis added).

3. **FINRA Investor Alert on Cybersecurity.** On February 3, 2015, FINRA also issued an Investor Alert entitled "*Cybersecurity and Your Brokerage Firm*" ("FINRA Alert") *available at* http://www.finra.org/investors/alerts/cybersecurity-and-your-brokerage-firm. The FINRA Alert encourages investors to understand their firm's cybersecurity policies. It includes a series of questions investors can ask to help them better understand their firm's cybersecurity activities and policies.

A.B.F.
October 2, 2015