# Practical Risk Management for Financial Advisors and Supervisors

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# Post-Madoff Regulatory/Litigation Environment

- Dodd-Frank Act reforms (fiduciary duty/SROs).
- SEC Enforcement Division commenced 681 cases and opened 531 investigations in FY 2010 (compared to 664 cases and 496 investigations in FY 2009).
- FINRA filed 1,310 disciplinary actions in 2010 (13% increase).
- 2010: Approximately 76 % of FINRA customer claimant cases resulted (settlements or awards) in recovery for the investor.
- 2010: 47% of FINRA panel awards favor claimants (45% in 2009).

FINRA NTM 11-05:

Claimants may choose an all-public panel for claims over $100,000




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# Heightened Reporting Obligations

- SEC Form ADV (Investment adviser registration with SEC and states).
- Form U4 (Uniform Application for Broker-Dealer Registration).
- Form U5 (Uniform Termination Notice).
- FINRA Rule 4530 (heightened reporting).
- FINRA Rule 8312 (more information available on Broker Check).




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# Rules/Commonly Asserted Claims

- Suitability
  - **NYSE Rule 405** (as of July 9, 2012, no longer applicable);
  - **NASD Rule 2310** (as of July 9, 2012, no longer applicable); and
  - **FINRA Rule 2111** (effective July 9, 2012).




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- Breach of Fiduciary Duty
  - Investment advisers v. broker-dealers
- Fraud / Unfair Trade Practices
- Churning
- Negligence / Failure to Supervise

# Avoid Risk Before Commencing Client Relationships

How do you address the challenge.

Avoid problem clients – sometimes the best decision is to turn a potential client away.

- The free-agent client.
- Shoehorning a client to fit your style.
- Client with unrealistic expectations.




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# Avoid Risk By Knowing Your Customer

Rules:

- **NYSE Rule 405** (as of July 9, 2012 no longer applicable);
- **NASD Rule 2310** (as of July 9, 2012 no longer applicable);
- **FINRA Rule 2090** (effective July 9, 2012); and
- **FINRA Rule 2111** (effective July 9, 2012).

# FINRA Rule 2111 clarifies obligations from NASD Rule 2310

"Investment strategy" broadly defined to include recommendation to hold securities; open issue in past.




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# How do you ‘know your customer” and document that knowledge?

- Account application / intake checklist.
- Employ a consistent fact gathering process.
- Client interview (face to face).
- Objective questionnaires.
- Ongoing client meetings (phone and in person).
- Account verification profiles at regular intervals.




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More complex transactions and less sophisticated clients require more evidence of KYC and suitability analysis.

# What are the key areas of focus?

- Personal information.
- Current financial position.
- Investment goals and objectives.
- Tolerance for risk.

This information should be reviewed on at least a yearly basis.

If unusual market, you should review this information with the client on a more regular basis.

Do not wait for the client to contact you; you expose yourself to risk and losing a client.




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Supervisors:  How do you verify KYC's?

Are you a rubber stamp?

# Key to Survival – Open and Honest Communication

Frequent communications with clients.

At least an annual face-to-face meeting and quarterly representative initiated telephone contact.

Return client phone calls within 24 hours at the latest.

If regular and consistent contact is part of your routine, you can defeat the claim that you had no contact with the client in rough times.

Talking to your client is a business development opportunity.

If circumstances warrant, there should be more frequent communications; e.g., large market swings either way.

Document all client meetings and communications (including recommendations); at least in the file.

Document in a writing to the client when client ignores your advice.

Document all transactions in accordance with firm standards and practices, and maintain those records.

SEC Rule 17a-3

Blotters, ledgers, purchase/sale memoranda, transaction confirmations, option records, proof of account balances, daily trade summaries, individual account customer profile, account agreements, customer complaints, signed compliance policy forms, authorizations for discretionary account, etc.




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# What If I Get Sued Anyway?

Sometimes you can do everything right and still get sued.

- Properly report the complaint up the supervisory chain.

- Cease communications with client, do not play lawyer or try to settle the claim.

- Gather documents -- you will be expected to have certain documents:




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## FINRA NTM 99-90 requires:

Account opening documents, statements, file notes, trade confirmations, customer complaints, U4, U5, RE3, compliance manual, exception reports, disciplinary records, commission and other compensation records, pertinent examination/audit reports, prospectuses and offering documents, records of customer phone calls, etc.




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Negative inference if you lack what you should have.

NEVER alter the file records or attempt after-the-fact papering of the file.

Make sure compliance/lawyer have the evidence to assess the case and present the best possible defense.

What do you do when complaining client remains with the firm.

# Social Media – The New Minefield

Trend for registered representatives and investment advisers to use social media as a form of communication and marketing.

FINRA and SEC have social media task forces to review social media issues.

FINRA suspended a California broker for one year for misrepresentative and unbalanced messages about investments on Twitter; also fined 10K.  Firm was not advised of the posts.  Separately, she also crafted a misleading personal web site touting her personal achievements.

**NASD Rule 2210** (rule re: communication with the public).

**Notice to Members 10-06 and 11-39**

Static versus interactive media distinguishes the level of supervision.

# Static content

**Static content** is treated like an "advertisement", which requires pre-approval from the registered principal before a posting is made.

Examples: Facebook personal page, blog, personal web page, etc.




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# Interactive media

**Interactive media** involves real-time postings; FINRA does not require registered principal pre-approval.

Examples: instant messaging, Twitter postings, etc.

NASD Rule 3010 requires reasonable supervision of interactive media to ensure that there are no violations of the communication rules.

Must retain records of communications related to its business conducted through social media; what you create, you must give to the firm.

If a firm or its personnel recommend a security through the social media, it will be considered a "recommendation" for suitability purposes.

Creates a significant suitability problem if the social media is open to the public.

Equivalent of cocktail party legal advice.

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