FIRMA™

2010 ISSUE 2

FORUM

Will Trustees Set the Bar for the Fiduciary Standard?

Fiduciary & Investment Risk Management Association™ Quarterly Magazine
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FIRMA UPCOMING EVENTS

FIRMA is pleased to offer the dates and locations for our upcoming Programs.
Please visit our website - www.thefirma.org - for the detailed information about each event.
We hope you can attend one of these outstanding programs!

Training Seminars

Chicago, IL
September 15 & 16, 2010

New York, NY
October 6 & 7, 2010

Houston, TX
November 5, 2010

25th Annual FIRMA National Risk Management Training Conference
Atlanta, GA
April 17-21, 2011

Teleconferences

FIRMA/ABA -

SEC Custody Rules
August 5, 2010

FIRMA/ABA - RegR
September 29, 2010

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FORUM

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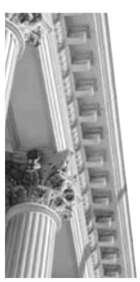
The Fiduciary and Investment Risk Management Association, Inc.™, supporting auditors, compliance officers and risk managers in financial services firms, and their service providers.

EDITORS' NOTE: In order to bring you the most up-to-date industry information, the FIRMA Board and Publications Committee have made the decision to provide more flexibility to the FORUM production schedule. Therefore, you will notice a change in the naming of each magazine. Beginning with this issue, we will no longer refer to the magazines with seasonal designations (Winter/Spring/Summer/Fall), but rather will have numbered issues for each calendar year. This current magazine is the second FORUM of the year, and therefore is 2010 Issue #2. We are proud to continue our commitment to you in providing four informative and timely magazines each year.

FIRMA DEPARTMENTS



THE MISSION OF FIRMA

Vision – Through commitment to professional excellence, we will be the premier fiduciary and investment risk management resource in the global financial services industry.

Mission – FIRMA is a member driven industry organization committed to:

- Providing comprehensive risk management knowledge and support through training opportunities and networking forums;
- Promoting exemplary professional conduct and high ethical standards in the practice of audit, compliance, risk management, and regulatory supervision;
- Addressing emerging issues in the fiduciary and asset management risk environment.

Core Principles – Expertise, Education, Networking, Member Value, Industry Influence

CONFERENCE UPDATE

The FIRMA 24th National Risk Management Training Conference

San Francisco, California

Contributed by Gary Pelcak, Co-Chair, FIRMA Education Committee

FIRMA celebrated its 24th annual National Risk Management Training Conference March 28 - April 1, 2010, at the historic and beautiful Palace Hotel in San Francisco, California. Kevin McCabe, EVP/Chief Auditor, Wells Fargo & Company, delivered the Opening Keynote Address, Where Do We Go from Here: Risk Management after the Financial Meltdown. Tuesday's Keynote Session consisted of a Banking Regulatory Panel. Jonathan Turner, CFE, Wilson & Turner, Inc. delivered Thursday's keynote session, Investment Fraud – Ponzi Rides Again. The conference offered two three-hour Pre-Conference Workshops, a comprehensive three and one half day program consisting of nine General Sessions, one In-Conference Seminar, four Town Hall Sessions, and 24 separate break-out sessions consisting of four separate study tracks. Other special events during the conference included a First Time Attendee Reception on Sunday Evening, FIRMA's Welcome Reception on Monday evening, a hosted luncheon, and the annual membership meeting.

Attendees meet conference vendors and sponsors during session breaks.

FIRMA President Keith Bujalski (L) and Director Bruce Goldberg

The two Pre-Conference Workshops, "Trust Boot Camp" and "Estate Tax Law Changes" offered attendees two benefits. First, they gained additional insights and the opportunity to sharpen their advanced skills. Second, attendees had the chance to arrive early and enjoy the many attractions, museums, and world renowned restaurants offered by the fabulous city of San Francisco.

The conference officially began on Monday, March 29, with opening remarks from FIRMA President Keith Bujalski who introduced and thanked the board members and the FIRMA team for all their efforts in planning this conference. Mr. Bujalski then introduced the kick-off speaker, Kevin McCabe. Mr. McCabe addressed the regulatory pressures and legislative reaction to the financial services crisis and described what will be expected of all companies to improve their enterprise risk management process and internal audit departments.

Mr. McCabe's presentation was followed by JanErik E. Aase. JanErik addressed vendor risk and how the "new normal" will and should not impact governance of third party vendors. Attendees were reminded that data protection, performance management, and risk mitigation are still a part of the vendor risk process.

Based on several requests from our members, Dr. Perry H. Beaumont, PhD., provided practical real-life case studies and solutions for valuing a variety of financial assets with a special focus on the challenges of today's global marketplace. Dr. Beaumont is President of CSV, INC. located in Richfield, Connecticut. He brought the perspective of both a practicing professional and an academic in his discussion of the "Top 10" list of things every professional should be aware of when it comes to maximizing valuation tools and resources.

In conjunction with the fabulous hosted luncheon on Monday, James F. Strickland, Chief Audit Executive, TDBANKNORTH, N.A., located in Portland, Maine, discussed the practical application of results from a FIRMA survey presented at last year's conference based on practices and tendencies in compliance, audit, and risk management oversight for broker-dealers and wealth management. Jim discussed tools and techniques that have proven effective in coordinating audit and compliance oversight activities in banks with broker dealers and wealth management business, the interaction with regulators, and what lessons have been learned from the industry events of the recent past.

Day One continued with a general session from the always popular Fran DeMaris, EVP – Cannon Financial Institute. Fran's presentation, "Conflicts of Interest - Red Flags," brought a fresh look, and gave us new ways and vigor on how to deal with blame, lawsuits, and our ability to manage the risks that we see daily in our

CONFERENCE UPDATE

Speaker Jim Strickland addresses the conference attendees.

industry. Fran reminded us that our ability to stay informed, develop forward thinking attitudes, and remain proactive separates us from others in a meaningful and positive way.

Day One concluded with four concurrent Town Hall Sessions covering Audit Brokerage and Investment Activities, Account Pre Acceptance – Asset Analysis, Control Self – Assessment Process, and Personal Trust Administrative Reviews. FIRMA is especially proud of the partnership we enjoy with risk management professionals and their respective employers that support these training sessions at our National Conference. We also want to commend the individual effort that is given to complete each session.

On Monday evening, all conference speakers, guests, and attendees were invited to attend the Welcome Reception in the hotel on the Sunset Court Level of the hotel. This event was again in response to requests from the FIRMA members for an event that would provide networking opportunities in a relaxed setting that would not take us out of the hotel. The food was fantastic! Friendships were renewed and many new ones made during this event. This reception was the perfect way to close the very busy and exhausting first day.

Tuesday of the FIRMA conference featured a Banking Regulator Panel as the keynote session followed by two general sessions and one In-Conference Seminar. During the keynote session, our primary regulators discussed their structures, changes, and the expectations of their representative financial institutions as well as management, audit, and compliance professionals. The unique format allowed attendees to hear how each agency is addressing financial reform. Tuesday's two general sessions covered the Trust Legislative Update presented by Sally Miller and Information Security by Matthew Speare. Sally delivered another not-to-miss session dealing with regulatory restructuring, too big-too-fail, and consumer financial protection. Mr. Speare addressed a series of how-to solutions for: applying risk management techniques to evolving computer security threats, evaluating your security infrastructure, deploying a security model that ensures critical data is backed up, replicated, and accessible, and discussed a list of common vulnerabilities with the newest attack techniques to effectively protect sensitive information.

This is the fifth year for the member-requested In-Conference Seminar. We will continue to offer the In-Conference to FIRMA attendees during the national training conference. This year's seminar titled, "Merger & Acquisition Due Diligence," was presented by Kim Dessormeau of TD BANKNORTH, N.A., Burlington, Vermont.

Wednesday offered four separate tracks consisting of Risk Issues, Operations Hot Topics, Asset Management, and Regulatory. Twenty-four breakout sessions were available which enabled all conference attendees to tailor the training sessions to their own needs. The breakout sessions included topics: Critical ERISA Issues, Operational Risk Management, Sub-Custodian Risk, Hedge Fund Risk Management, Dual Hatting, Enterprise Risk Management, Class Actions and SEC Settlements, Critical IRA Issues, and Third Party Money Manager Due Diligence.

Wednesday's end-of-day sessions, the Large and Small Bank Roundtables, the Investment Advisor Roundtable, and the Regulatory Roundtable always provide an interesting exchange of ideas as well as a forum for identifying solutions to complex problems.

Also on Wednesday, the FIRMA Annual Membership meeting was scheduled in conjunction with lunch. All FIRMA members and non-members were welcomed to attend. Committee updates were provided for all FIRMA Committees, and addressed the many accomplishments and current initiatives of the FIRMA Association. The Board encouraged members to get involved by joining committees and promised that the experience will be extremely rewarding.

During the opening remarks on Thursday morning, Larry Musher, FIRMA Nominations Committee Chair, welcomed back Keith Bujalski, Bridget Kovalik, and Michael Daly for their second terms as members of the FIRMA Board of Directors. Larry noted that Keith Bujalski was re-elected as President, Gary Pelcak was re-elected as Vice President and Bridget Kovalik was re-elected as Secretary to the FIRMA Board.

On Thursday, the last day of the conference, the lead-off Keynote Session was Investment Fraud – Ponzi Rides Again, presented by Jonathan E. Turner. Mr. Turner, a Certified Fraud Examiner (CFE), discussed the schemes that were formerly perceived as small scale that must now be acknowledged as some of the most prime money makers in the world. He used these schemes as a model to highlight the features of successful fraud schemes, identified the keys to their success, and the techniques necessary to counter them. The second general session, "Business Resumption or Business as Usual – They are Closer than You Think," was presented by Larry Kallembach. Larry addressed what is important in running your business and how to build resumption planning into your "business as usual" day.

F. Jay Meyer concluded the morning with his presentation, "Sharing Information with Affiliates and Third Parties."

The FIRMA Board of Directors would like to thank all of the professional educators and supporters of our national training conference, as well as all of our members and other conference attendees. Plan now to attend FIRMA's 25th National Risk Management Training Conference April 17-21, in Atlanta, Georgia, at the spectacular Atlanta Marriott Marquis.

FIRMA Director Larry Musher introduces the Banking Regulator Panel.

COVER STORY

Duties of Trustees and Other Fiduciaries

Will Trustees Set the Bar for the Fiduciary Standard?

By Janice J. Sackley, CLU, CFE

Author's Note: *This article originally appeared in the March/April 2010 edition of NSCP's* Currents *as an education piece for brokers. At the time this edition of* FIRMA FORUM *is finalized, the House has passed the conference committee version of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The "Fiduciary Standard" provision of the bill requires the SEC to conduct a study within six months to evaluate the effectiveness of the standards of care of certain industry financial advisors, including investment advisers, brokers and dealers, but not bank fiduciary investment advisors or other investment fiduciaries outside the SEC's jurisdiction. The bill also grants the SEC rule-making authority on this issue, including the authority to establish a fiduciary duty for brokers. Regardless of the outcome of the legislation or its final language, rest assured that the focus on customer standards of care (a "fiduciary" standard, a "best interest" standard or a "suitability" standard) will continue by regulators, industry professionals and the financial press in the months and years ahead.*

What is a Fiduciary?

A survey of definitions of the word "fiduciary" offered by academics, attorneys and judges in textbooks, legal dictionaries, articles, journals, court decisions and other published material results in recurring terminology that is commonly used to describe a fiduciary and the relationship with the person that is owed a duty. The words trust, candor, honesty, loyalty and power are found frequently. Certain phrases that crop up with regularity, such as "utmost good faith", "avoid self-dealing", "avoid conflicts of interest", "sole interests" (and sometimes,"best interests"[1]), and "undivided loyalty" are often used to describe the obligations of the fiduciary.

No matter the words used to describe a fiduciary relationship, there does seem to be universal consensus that a fiduciary obligation imposes the highest possible standard of duty that one party can owe another under the law.[2]

Think about the many fiduciary relationships that occur in life:

Attorney-Client
Executor-Estate
Director-Corporation/Stockholders
Partner-Partnership
Plan Sponsor-Plan participants
IRA Trustee-IRA Owner/Beneficiary
Attorney in fact-Principal (under Power of Attorney)
Conservator-Protected person's estate
Guardian-Ward
CPA-Client
Executive Director&Board-Charity/Foundation
Mayor/Councilpersons-Municipality
Parent-Child
Investment advisor-client
Trustee-Beneficiaries

There are many other relationships not listed here that could give rise to fiduciary obligations. Basically, a fiduciary relationship exists when an individual or firm has the duty to act for the benefit of another party under an umbrella of trust, confidence and dedicated loyalty.

Why do trustee duties matter?

This article is intended to highlight the basic duties of a trustee, a type of fiduciary that has well-established principles rooted in the common law. The duties ascribed to trustees, especially the duty of loyalty, are often benchmark standards for other types of fiduciaries. The reader may be surprised to learn that banks and thrifts that utilize their trust powers to enter into agency relationships with customers to manage their funds are subject to the same fiduciary principles that apply to trustee relationships, per trust banking law and many state statutes ("investment advice for a fee" is a fiduciary capacity).[3]

A better understanding of trustee duties may enable the compliance officers of broker-dealers, financial planning firms, investment advisory firms, and insurance firms to conduct a better assessment of the current business practices in their shops with an eye towards what might be expected in the future if a fiduciary standard of behavior ever becomes the controlling principle for certain customer relationships. Or, where fiduciary relationships already exist, a deeper understanding of trustee duties can help the reader better assess the adherence of current practices to true fiduciary principles.

This briefing is not intended to be a scholarly dissertation on all of the legal interpretations of trustee duties as evolved over the ages through court opinions. Although these historical interpretations are very important because ultimate liability is ascribed by a court based on these definitions and precedents and not on bank trust law per se, it would not assist the reader in figuring out what must be analyzed with respect to basic business practices. Whole textbooks and law school classes, and even degrees (for example, Campbell University offers a major in Trust and Wealth Management), are offered in the realm of the fiduciary.

Pending legislation, discussed below, is often the disdain of compliance officers who already have too much on their plates. But the fact remains that there is heightened discussion of a possible fiduciary standard for financial intermediaries. Those compliance officers and firm executives who have not previously been exposed to fiduciary standards may wish to be better prepared for significant changes to current business models that may be required in the future should a fiduciary standard become the norm.

Customer Expectations

Even more of a driver than possible legislative or regulatory dictates is the fact that discussion of fiduciary standards is no longer limited to trade publications, courtrooms, and the halls of Congress. Popular consumer financial publications, daily newspapers, blogs, and cable news shows have all published stories about the "fiduciary standard" or have used the word "fiduciary" to describe duties between parties, albeit sometimes inaccurately.

Some industry financial writers urge investors to demand a fiduciary level of duty from their brokers and advisors. Such encouragement serves to create new customer expectations. Financial professionals are likely to be asked by some customers, if they have not been already, to whom they owe allegiance when making recommendations on the purchase of a security, fund or insurance product. Thus, firms would be wise to elevate their understanding of what customers expect, how a fiduciary standard may impact their business models, and which marketing approaches, business practices, policies, procedures, and training may require adjustment should changes become necessary.

Trust Firms

There are some firms that are better prepared than others for these fiduciary assessments. For example, a number of broker-dealer firms are affiliated with financial service companies or bank holding companies that may own banks or thrifts with trust powers, and these affiliates may have fiduciary expertise on staff as well as fiduciary counsel. Also, some financial firms, where permitted under state law, have organized private trust companies. Others have organized limited or special purpose (non-deposit) banks with trust powers.

There have also been cases where individual advisory employees have agreed to act as trustee or as successor trustee for clients who are trust settlors, hopefully only with the approval of their firms and only after an educated risk assessment of the potential pitfalls and firm liability.

Depending on how the trust firm is organized, regulatory oversight could be under the purview of any one (or more) regulators, such as state banking regulators, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve or, for state non-Fed member banks, the Federal Deposit Insurance Corporation (FDIC). Each of these regulatory agencies has experienced fiduciary examiners on staff who conduct exams annually or, in the case of large banks, continuously. These regulators take the view that all activities pursuant to the bank's trust powers, including all services where investment advice is rendered for a fee (whether or not a trust is involved), is fiduciary activity.[4]

Duties of the Trustee

There are commonly accepted duties of trustees, and they are articulated in authoritative publications on trusts[5] as well as in the issuances of regulators that oversee financial firms such as banks that act as trustees.[6] Here is a partial list of the principle duties of a trustee:

- **Duty of Loyalty** A trustee must administer a trust solely in the interests of beneficiaries. A trustee must not engage in acts of self-dealing. *This is the most fundamental duty of a trustee.*
- **Duty of Administration** A trustee must administer a trust in accordance with its terms, purposes and interests of the beneficiaries. A trustee must act prudently and exercise reasonable care, skill and caution.
- **Duty to Control and Protect Trust Property** A trustee must take steps to control of and protect trust assets.
- **Duty to Keep Trust Property Separate and Maintain Adequate Records** A trustee must keep trust

property separate from the trustee's own property (no commingled accounts) and render clear and accurate records with respect to trust administration.

- **Duty of Impartiality** A trustee must act impartially if there are two or more beneficiaries, with respect to investing, managing, and distributing trust assets.
- **Duty Not to Delegate** A trustee should not delegate functions to others that it can reasonably perform itself, and may not transfer the position of trustee to another. [Note; many states now permit delegation of certain duties, such as investment management, pursuant to statute].
- **Duty to Furnish Information** A trustee must keep beneficiaries reasonably informed about the administration of the trust and of material facts necessary for them to protect their interests.
- **Duty of Prudent Investment** A trustee who invests and manages trust property has a duty to comply with the prudent investor rule unless otherwise stated in the trust terms or permitted by state law.
- **Duty to Enforce and Defend Claims** A trustee must take reasonable steps to enforce claims of the trust and to defend claims made against the trust.

It is important for the non-fiduciary professional to recognize from the above list that the myriad of duties that a trustee must fulfill are not all related to the actual investment management of trust assets. Some investment professionals have been surprised when confronted with these other duties and the level of knowledge and skill it requires to properly execute them. For example, adhering to the language of a trust instrument (Duty of Administration) generally requires an understanding of the accepted legal interpretations of certain terms. Such understanding is usually obtained by years of guided mentoring by experienced trust administrators along with input from fiduciary attorneys.

Below are brief highlights of selected duties.

Duty of Loyalty/Conflicts of Interest

The Duty of Loyalty is one that applies to all fiduciaries and thus deserves special emphasis. As noted above in the list of trustee duties, loyalty is really the foundation of the trust relationship and is the crucial element of the trustee's obligations. A fiduciary is in a special position of power and expertise and the other party is relying on the fiduciary to act with prudence and without regard to the fiduciary's own self-interests.

The Duty of Loyalty is the duty that most frequently gives rise to conflicts of interest. Its application to those who give investment advice creates uncertainty for some as to what is permissible conduct and what is not. Conflict situations frequently are not black and white and do not have clear solutions in all cases.

Internal debates about conflicts can be rather routine in a large fiducial firm, and the application of the Duty of Loyalty can invoke controversial discussion of the fiduciary standard. A trustee is required to avoid conflicts. Certain conflicts can be waived specifically in the governing instrument, by statute or court order[7], or by waiver from every beneficiary to the trust. In the case of unborn beneficiaries or minor beneficiaries to the trust, a guardian ad litem may have to be appointed by the court to represent their interests. The commentary to Section 802 of the Uniform Trust Code explains further:

> *Subsection (b) states the general rule with respect to transactions involving trust property that are affected by a conflict of interest. A transaction affected by a conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary who is affected by the transaction. Subsection (b) carries out the "no further inquiry" rule by making transactions involving trust property entered into by a trustee for the trustee's own personal account voidable without further proof. Such transactions are irrebuttably presumed to be affected by a conflict between personal and fiduciary interests. It is immaterial whether the trustee acts in good faith or pays a fair consideration. See Restatement (Second) of Trusts Section 170 cmt. b (1959).*
>
> *… Under subsection (c), a transaction between a trustee and certain relatives and business as-*

sociates is presumptively voidable, not void. Also presumptively voidable are transactions with corporations or other enterprises in which the trustee, or a person who owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment. The presumption is rebutted if the trustee establishes that the transaction was not affected by a conflict between personal and fiduciary interests. Among the factors tending to rebut the presumption are whether the consideration was fair and whether the other terms of the transaction are similar to those that would be transacted with an independent party.

Even where the presumption under subsection (c) does not apply, a transaction may still be voided by a beneficiary if the beneficiary proves that a conflict between personal and fiduciary interests existed and that the transaction was affected by the conflict. The right of a beneficiary to void a transaction affected by a conflict of interest is optional. If the transaction proves profitable to the trust and unprofitable to the trustee, the beneficiary will likely allow the transaction to stand. For a comparable provision regulating fiduciary investments by national banks, see 12 C.F.R. Section 9.12(a).

In the asset management world and for insurance agency sales, potential conflicts arise from not only the related interests of the individual investment professional, but also the related interests of the employing or licensing firm and any subsidiaries and affiliated companies, agencies, employees, officers and directors. Products and services manufactured by the fiduciary or its affiliates, or which yield sales commissions, mark-ups, ongoing revenues, or other favorable benefits, both direct and indirect, to any of these parties are considered conflicts of interest. A bank acting in a fiduciary capacity must meet the same conflict waiver requirements for its agency relationships as for its trustee relationships.[8]

"Favorable benefits" may include non-financial benefits, such as depletion of an unattractive asset from a firm's inventory even where all mark-ups are removed, valuation methodologies, common directors, or other situations.[9]

Non-trustee fiduciary relationships can meet the waiver requirement in some cases through the use of disclosure and consent by the account owner. Such disclosures act, in essence, as amendments to the agency agreement. But the requirements for a conflict waiver disclosure are not to be taken lightly as they are far more nuanced than one might think.

Disclosures and Consents

A consent to a waiver of a conflict of interest on the part of a trustee can withstand scrutiny only if there is full, fair, honest and conspicuous disclosure of all information that would be material to the customer's decision to grant consent to the conflict. Furthermore, the information about the conflict must be understood by the customer as the decision to waive the conflict must be done on a fully informed basis.[10] Put yourself in the shoes of the customer and ask what you would want to know about the possible benefits to the fiduciary if you were deciding whether or not to grant consent to a conflicted transaction.

It is very important to note that some SEC-accepted methods of handling conflict disclosures by registered investment advisors are not condoned by banking regulators for a bank fiduciary, whether in a trustee capacity or an agency capacity. For example, disclosures without accompanying consent specifying the use of products or services of an affiliated company that are made in a Form ADV would not be adequate for a bank fiduciary. Absent language in the governing trust, court order, or statutory exemption, the disclosure provided by a trustee must meet the "full and fair" hallmarks discussed above, be understood by the party granting the waiver, and the subsequent consent obtained only if these requirements are met. General language is not normally considered adequate to relieve the conflict absent precedent in the courts or statutes of jurisdiction[11].

Many conflicts are impermissible regardless of whether or not customer consent is obtained. For example, it is a felony for a bank trustee to loan funds from a trust it administers to any bank officer, director or employee.[12] Neither client direction nor court order can override this prohibition.[13] To illustrate how restrictive this law is, if the trust grantor is a parent of a bank employee, a loan from the trust cannot be made to the bank employee even if he or she is a beneficiary of the trust or even if the grantor is insistent that the bank trustee make the loan.

Another example is that prohibited transactions under ERISA or the Internal Revenue Code for qualified plans and IRAs cannot be waived by a plan sponsor, participant or IRA owner.[14]

Some conflicts of interest for fiduciaries can be overridden by statute. For example, nearly all states permit a corporate trustee to invest in affiliated mutual funds where an RIA affiliate may also be the investment advisor to the funds.[15] The Uniform Trust Code has provisions to permit these investments, though a majority of states have not adopted the Code and some have amended various parts.[16] Some states require an offset against the trustee's fee in the same amount as the fund advisor receives. Other states do not have this requirement but in certain situations the bank trustee may voluntarily reduce its overall trustee fee. The reason for doing is that the total fees received by the trustee, including any funds received by affiliates and subsidiaries, must be reasonable.[17]

Duty to Control and Protect Trust Property

Some investment advisors and brokers have expressed frustration or questioned why a bank trustee insists on holding the assets of the trust and refuses to permit custody in the hands of a broker custodian when an investment advisor has been hired to manage the assets of the trust. This insistence is more easily understood once the investment professional understands the trustee's obligation to "Control and Protect Trust Property".

It is incumbent on the trustee to retain possession and control of all trust assets wherever possible. Certain situations, of course, require the engagement of outside facilities or custodians, but only after prudent due diligence. For example, if the trust property includes art work, precious metals, or other physical assets it may not be feasible for the trustee to store these assets and may require the use of a proper facility in order to properly secure and preserve the asset.

Even where trust property is used as loan collateral or as security for a derivative such as a prepaid variable forward contract, the trustee must generally hold the assets or otherwise retain control to prevent distribution by an unauthorized party that does not have distributive powers. If necessary the trustee can keep assets separate from other property of the trust specifically for the benefit of the counterparty in the event the assets are needed to honor a security obligation. The use of securities depositories are permitted.

Duty of Impartiality

In any investment setting (RIA, broker, trustee, bank investment manager, etc) a portfolio manager who is making investment recommendations for assets held in a trust, especially an irrevocable trust, should be balancing the needs of current beneficiaries against the needs of remainder beneficiaries. Are your brokers and advisors adequately trained to understand these differences if they are managing trust assets where the grantor does not have discretion? For example, if the current income beneficiary is demanding high payouts and presses for investment in low rated, high interest bonds, is that balanced against the desire of remainder beneficiaries to preserve or grow principal?

While this is a simplistic description of the Duty of Impartiality, there are several statutory provisions and industry practices that may temper this duty, such as taking into account non-productive trust assets, the current financial situation of the income beneficiary, permissibility in the jurisdiction for total return trusts, and most importantly, the intent of the grantor as articulated in the governing instrument. It may be of interest to non-trustee investment professionals to learn that trustees are expected to review the financial statements and even tax returns of income beneficiaries who make distribution requests to ascertain their true needs prior to distributing any principal which would decrease the ultimate trust corpus for remainder beneficiaries.

Possible Fiduciary Standard for Brokers

Brokerage and insurance executives as well as compliance officers may have expressed a sigh of relief upon hearing that there was no fiduciary standard mandate in the draft financial reform bill passed by the Senate Banking Committee on March 22, 2010, entitled "Restoring American Financial Stability Act of 2010".[18] However, the House version, "Wall Street Reform and Consumer Protection Act of 2010"[19] does contain a requirement that investment advice rendered by a broker be under a fiduciary standard. While there are some other provisions of concern to those who are promoting a fiduciary standard, this provision seems to, for the most part, accomplish the Administration's goal as set forth in the Obama Administration's White Paper on financial reform[20]. In addition, some SEC Commissioners have been vocal about their view that a fiduciary standard is an important element of investor protection.[21]

It remains to be seen what final Senate legislation may contain and what results from the reconciliation process.

Studies Demanded by Draft Bill

Instead of requiring a fiduciary standard out of the blocks, the draft Senate committee bill demands 16 studies, two of which are about standards of care.[22]

First, the bill requires the Comptroller General of the United States to study various aspects of the Commodity Futures Trading Commission and the Securities Exchange Commission regarding 1) jurisdictional disputes; 2) holding futures and securities in the same account for cross-netting; 3) possible "harmonizing" of laws and merging of agencies, and 4) the benefits and feasibility of imposing a uniform fiduciary duty on financial intermediaries who provide similar investment advisory services.[23]

Of perhaps even greater interest is the draft bill language that calls for a "Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers".[24] This study is to look at regulatory gaps as well as the practices of FINRA and the SEC with respect to enforcing "the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers when providing personalized investment advice and recommendations about securities to retail customers."

This same section of the bill directs the SEC to consider "the specific instances in which—(A) the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of brokers and dealers; and (B) the regulation and oversight of brokers and dealers provide greater protection to retail customers than the regulation and oversight of investment advisers…"[25]

In addition, the study is to cover a number of other elements. The fiduciary standard comes into play due to the provision that states that the study is to assess the potential impact on the access of retail customers "to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers and persons associated with brokers and dealers—(A) the standard of care applied under the Investment Advisers Act of 1940 for providing personalized investment advice about securities to retail customers of investment advisers; and (B) other requirements of the Investment Advisers Act of 1940."[26]

Recall that the Investment Advisers Act of 1940 does not actually mention the word "fiduciary," but numerous court cases have firmly established that a fiduciary duty is owed by an advisor to a client.[27]

Why Care About Pending Legislation?

Even though the imposition of a fiduciary standard on brokers and insurance agents does not, for the moment, appear imminent, it would be prudent for a firm's regulatory risk and compliance departments, and others with regulatory assessment responsibility, to think about their firm's business model and what would be the likely impacts on business practices should a fiduciary standard become reality for all employees who render personalized investment advice.

Discussions with firm owners and executives should commence to educate and prepare management for possible changes that will require their long-term planning. Perhaps you could start with this article.

To undergo a "fiduciary standard" assessment, it is necessary to understand what the business practices and governance structure of the firm are in order to identify those behaviors and structures that may create a fiduciary relationship with the customer[28]. Those activities then should be reviewed to determine if the firm's business model requires modification, if certain services will be discontinued to avoid a fiduciary duty, or determine if a fiduciary duty will be embraced. If the latter, substantial effort will have to be put forth to be sure that business practices are revised to comply with fiduciary principles.

What Business Practices Should Be Analyzed?

The present challenge for compliance officers at broker-dealers is to take time, before any final legislation is passed or new regulations are introduced, to assess the business model at their firms. Look at all the types of interactions representatives or call centers have with customers, know what the customer expectations are, and figure out where and how changes may need to be made to eventually comply with a fiduciary standard in areas where it currently is not applicable. Most importantly, the compliance officer must be able to articulate the implications of such a standard to the business executives who are responsible for determining the organizational structure of the firm and establishing service delivery.

Here is a list of just some of the issues common to many broker-dealers that should be addressed in a comprehensive assessment.

- **Commissions.** This subject is a hot issue, with some insisting that fiduciary duty does not preclude receipt of commissions. Any type of financial benefit to the fiduciary for an action or inaction in the account, under the fiduciary's discretion, is an indisputable conflict of interest.[29]
- **Affiliates and Subsidiaries (Related Interests).** Does your firm have any affiliates or subsidiaries that provide services where the customer is paying for such services? For example, an investment advisor may have an affiliate broker-dealer, and vice versa. Or you may have an affiliated broker engaged in capital markets activity that provides an inventory of stocks or bonds for your representative to sell to customers. Another conflict situation is where an advisor or representative facilitates the purchase of an insurance product through an affiliate, where commissions are payable to the firm or the advisor and not refunded to the customer.[30]
- **Securities Lending.** A fiduciary who lends its customer's securities out without compensating the customer is using the customer's property for its own benefit.
- **Margin Lending.** If a fiduciary recommends a margin transaction in a customer account, it would be a conflict for the fiduciary to earn interest or fees from the resulting loan.
- **Customer-Directed Transactions.** It is unknown if the imposition of a fiduciary standard on brokers would provide a framework for a non-fiduciary capacity for those customers who entirely self-direct.
- **Training and Education.** Any new heightened standards will require a significant training effort of registered representatives, insurance agents, and other customer-contact employees who are unfamiliar with fiduciary requirements. It won't be a matter of only explaining what a fiduciary is; new business practices and procedures, new documentation, and the story behind it all will need to be communicated in order to make representatives both comfortable and effective.
- **Marketing and Advertising.** All materials should be reviewed to assure that there are no promises of fiduciary-type duties unless a business decision has been made to embrace fiduciary standards, or the services rendered require fiduciary duties under regulations or statute.
- **Sales.** The mindset of a fiduciary is not one of a seller of product. A fiduciary is a purchaser of individual securities, funds, insurance, or other investment products that meet the needs of the client and are solely in the client's best interests.

COVER STORY

- **Titles of Personnel.** Do your registered representatives and agents use titles containing the word "advisor", "strategist", "counselor" or other words that might create a false impression in a customer's mind that you are acting solely in their best interests? If you do not intend to establish a fiduciary relationship with the customer, you should re-examine such titles and recognize that they may imply a standard of care in the customer's mind that you do not intend to create nor deliver.

Complicated Challenges

In reality, in spite of all the versions of rhetoric in proposed legislation, the "fiduciary standard" will not simply be what trade associations or even what regulators say it is. These entities can provide guidance and best practices and try to develop industry standards. The actual fiduciary standard is set by customer expectations and what our jurisprudence system has imposed, using two hundred years of past court decisions. The decisions of the future will rely heavily on the ones from the past. The principles adhered to by the fiduciary-trustee will likely be a frequent measure by which other fiduciaries will be judged in the future.

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1. "Sole" versus "best" interests of the party to whom the fiduciary owes a duty is a distinction that can have significant implications. Academic discussions on this distinction include the argument that "best interests" permits a trustee to take an action to benefit a trust that may also have some benefit to the trustee, and thus is not "solely" in the beneficiary's interest. The counter-argument is that "sole" interest requires "no further inquiry," ie if there is any benefit to a trustee, the action cannot be taken. Space does not permit an in-depth discussion of this point.

2. Black's Law Dictionary 523 (7th ed. 1999);*FDIC v Stahl,* 854 F.Supp 1565 (S.D. Fla., 1994); *People v Township Board of Overyssel,* 11 Mich 222 (1863); *Donovan v Bierwirth,* 680 F .2d 263, 272 (2d Cir. 1982); *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996);and the oft-quoted Justice Cardozo in *Meinhard v. Salmon,* 164 N.E. 545, 546 (N.Y.1928). All quotations omitted.

3. 12USC9.2 and 9.101;12USC550.30

4. IBID.

5. *Restatement of the Law(Third), Trusts, Volume 3, American Law Institute; Scott on Trusts, The Law of Trusts, Volume IIA,* Austin Scott and William Fratcher; *Bogert's Trusts 6th,* George Bogert; *Uniform Trust Code, Article 8,* passed by several states both with and without modifications, available here: http://www.law.upenn.edu/bll/archives/ulc/uta/2005final.htm

6. See for example, Office of the Comptroller of the Currency, *Comptroller's Handbook, Personal Fiduciary Services,* 2002, page 19, available here: www.occ.treas.gov/handbook/pfsfinal.pdf

7. Comptroller of the Currency, *Comptroller's Handbook, Conflicts of Interest,* 2000, page 5 available here: www.occ.treas.gove/handbook/conflict.pdf

8. Comptroller of the Currency, *Comptroller's Handbook, Conflicts of Interest,* 2000, page 30-36 available here: www.occ.treas.gov/handbook/conflict.pdf

9. The conflict of interest that exists with respect to principal trades, *i.e.,* purchases made from a firm's inventory, is part of the fiduciary standard debate. Such purchases from inventory of an affiliated broker by a bank fiduciary are prohibited 12CFR9.12(a)(1), and purchases of any asset underwritten by an affiliate of a bank fiduciary is subject to severe restrictions and onerous requirements as outlined in Regulation W (12USC371c-1(b)(1). One of the requirements, for example, is prior permission from the bank's board of directors.

10. *Uniform Trust Code, Section 1009*."BENEFICIARY'S CONSENT, RELEASE, OR RATIFICATION. A trustee is not liable to a beneficiary for breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach, or ratified the transaction constituting the breach, unless: (1) the consent, release, or ratification of the beneficiary was induced by improper conduct of the trustee; or (2) at the time of the consent, release, or ratification, the beneficiary did not know of the beneficiary's rights or of the material facts relating to the breach."

11. 12 USC 9.12. Also see *Comptroller's Handbook: Conflicts of Interest,* page 5.

12. 12 USC92a(h): Loans of trust funds to officers and employees prohibited; penalties. It shall be unlawful for any national banking association to lend any officer, director, or employee any funds held in trust under the powers conferred by this section. Any officer, director, or employee making such loan, or to whom such loan is made, may be fined not more than $5,000, or imprisoned not more than five years, or may be both fined and imprisoned, in the discretion of the court.

13. *Comptroller's Handbook: Conflicts of Interest,* 2000, page 34: *When a bank officer makes such a loan or receives such a loan's proceeds, both the officer and the bank have committed a crime. For the bank to violate this statute, it need only be the trustee of funds that are lent to the officer, director, or employee. The fact that the transaction was executed at the direction of one or more persons does not make the bank any less culpable.No exceptions to this prohibition are allowed under 12 USC 92a(h). The statute prevails over any instrument authority, beneficiary consent, or court order purporting to authorize the transaction.*

14. A Prohibited Transaction Exemption, or Class Exemption, is required to overcome banned conflicts under ERISA and the Internal Revenue Code's "exclusive benefit rule." See ERISA 406 and IRC 4975.

15. Such statutory permission in no way relieves the fiduciary of the Duty of Prudent Investment. The OCC, for example, makes clear that *"the bank must keep in mind its obligation to act solely in the best interests of account beneficiaries."* The prescribed requirements include making a determination that the investment meets the needs of the account and that it continues to be appropriate in the future. See *Comptroller's Handbook: Conflicts of Interest,* 2000, page 43.

16. Uniform Trust Code, Section 802:

(f) An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust. If the trustee receives compensation from the investment company or investment trust for providing investment advisory or investment management services, the trustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee's annual report of the rate and method by which that compensation was determined.

17. See Uniform Trust Code, Section 708 and commentary, available here:
http://www.law.upenn.edu/bll/archives/ulc/uta/2005final.htm

18. http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf

19. See section 7103, H.R. 4173 Wall Street Reform and Consumer Protection Act of 2009 available here:
http://www.thomas.gov/cgi-bin/query/z?c111:H.R.4173:

20. A New Foundation: Rebuilding Financial Supervision and Regulation issued by the Department of the Treasury, excerpted here: *"The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest."* Available at www.financialstability.gov/docs/regs/FinalReport_web.pdf

21. See, for example, speech by SEC Commissioner Elisse Walter February 25, 2010
http://www.sec.gov/news/speech/2010/spch022510ebw.htm and speech by SEC Commissioner Luis Aguilar March 26, 2010
http://www.sec.gov/news/speech/2010/spch032610laa.htm

22. Restoring American Financial Stability Act of 2010. No Bill number available at press time. Bill available here: http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf

23. Ibid Sect. 763(a)(5), page 717.

24. Ibid Sect. 913(b), page 767.

25. Ibid Sect. 913(c), page 769.

26. Ibid Sect 913(c), page 770.

27. See, for example, *SEC v. Capital Gains Research Bureau, Inc.,* 375 U. S. 180, 194 (1963)

28. Bear in mind that even for broker-dealers, there are fiduciary duties with respect to the custodianship and safeguarding of customer securities, crediting of dividends, following corporate action instructions, and fund disbursements. Other activities, including acting as securities lending agent for a pension plan or other customer, may also give rise to a fiduciary duty. The subject legislation addresses the investment advice context.

29. Commission conflicts can, for certain account types, be remediated by proper disclosure and consent, return of the commission to the account where permitted by law, or by other methods authorized by statute.

30. Rebates of insurance commissions are prohibited in many states.

Overview of the Department of Labor's Spring 2010 Regulatory Agenda

Roberta Ufford

J. Matthew Calloway

By Roberta J. Ufford and J. Matthew Calloway

On April 26, 2010, the Employee Benefits Security Administration of the U.S. Department of Labor ("Department") released its semiannual regulatory agenda, which lists regulations the Department expects to have under active consideration and its regulatory priorities. Although final action on these matters may be months (or even a year or more) away, financial institutions may wish to consider the effects of coming regulatory changes on the services they provide to ERISA-covered plans.

Fee Disclosure Initiatives

The Department has been focused on increasing transparency of pension plan fees and expenses for several years. Two fee disclosure regulations under development by the Department are expected to be issued in final form this year. The first would require pension plan service providers to make detailed disclosures about their compensation and conflicts of interest. This regulation was proposed in December 2007, and the Department expects to publish an interim final regulation by late Spring 2010.

The second fee disclosure regulation would require disclosure of information about plan fees and expenses to participants in 401(k) and other participant-directed plans. The regulation is expected to enhance the information currently required to be furnished to plan participants. A proposed regulation was released in July 2008, and the Department expects to issue a final regulation in September 2010.

Definition of Fiduciary

A longstanding Department regulation establishes criteria for determining when a person providing investment advice to a plan is an ERISA fiduciary. (See 29 C.F.R. § 2510.3-21.) The Department is considering amending this regulation to take into account current practices of investment advisers and the expectations of plan officials and participants, with the effect of broadening the kinds of activities that would be considered fiduciary investment advice. The regulatory agenda identifies June 2010 as an expected date for issuance of a proposed rule.

Lifetime Income Options

The Department is continuing to explore what steps it could take to facilitate access to and use of lifetime income arrangements designed to provide a stream of income to participants after retirement. The Department believes that participants in 401(k) and other defined contribution plans, who are generally responsible for directing their own retirement savings, could benefit from lifetime income arrangements to help reduce the risk that they will run out of funds during their retirement years. However, the Department has noted that use of lifetime income options is currently very limited. A request for information was issued on February 2, 2010 to obtain more information, and the comment period ended on May 3, 2010. No date has been provided for further action.

Participant Investment Advice

In March 2010, the Department re-proposed a regulation implementing ERISA's prohibited transaction exemption for the provision of investment advice to participants in 401(k) and similar plans, as well as individual retirement accounts. This "re-proposal" followed the Department's withdrawal of a final regulation and class exemption issued in January 2010, which would have provided somewhat broader relief for investment advice programs. The newly proposed regulation would permit participant investment advice where either (a) the fees received by the individual providing the advice, and the advisory firm employing that individual, do not vary based on the advice provided (the level fee approach), or (b) the fiduciary adviser provides advice using a computer model certified annually by an independent expert (the computer model approach). The final regulation is scheduled for December 2010.

Target Date Funds

More 401(k) and similar participant-directed plans are offering target date funds as investment options. Target date funds have become increasingly popular since being included as one of the types of investments that are qualified default investment alternatives under the Department's regulation for participants who do not provide investment direction. (See 29 C.F.R. § 2550.404c-5.) However, not all target date funds have the same design, a fact that was highlighted by varying losses among 2010 target date funds during the financial crisis. The Department and the Securities and Exchange Commission ("SEC") jointly engaged in an examination of target date funds for nearly a year to provide guidance for investors, including fiduciaries and participants of ERISA plans, in understanding the operations and risks of investing in target date funds.

On May 6, 2010, the Department and SEC issued a joint investor bulletin on target date funds. The investor bulletin emphasizes the importance of evaluating a target date fund's investment strategy, underlying investments, changes in underlying investments over time, and risks. In addition, the investor bulletin explains that it is important for investors to review the prospectus or other fund information, because similarly dated target funds offered by different managers may have different investment strategies and risks. The investor bulletin also identifies additional factors that investors should consider in deciding whether to invest in a particular target date fund, including fees and expenses.

The regulatory agenda describes two additional regulatory projects directed at target date funds. The first is a fiduciary checklist providing tips for ERISA plan fiduciaries in selecting target date funds for their retirement plan investment portfolios. The Department also intends to amend its existing qualified default investment alternatives regulation to enhance the information provided to participants in connection with plans that utilize a target date fund as the plan's default investment. The Department anticipates issuing a proposed rule in August 2010.

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FIRMA FORUM Quiz

This print version of the quiz is provided for your reference. Please submit the quiz online at www.thefirma.org -- from the "For Members" tab, choose FORUM Continuing Education Quizzes. Members who prepaid for all 2010 quizzes with the Winter issue will be taken directly to the current quiz upon signing in. Members who did not prepay will be asked to generate an invoice prior to accessing the current quiz.

You may refer to the Regulatory Update and industry articles in the 2010 FIRMA FORUM Issue #2 as you take the quiz. Choose the one best answer from the alternatives provided. Questions are worth ten points each. A score of 80% or higher is required to earn five (5) FIRMA-specific continuing education credits. All pass/fail notifications will be emailed after the submission deadline has passed and payment has been received.

**** The 2010 FORUM Quiz #2 must be completed and paid by July 30, 2010****

1. On May 26, 2010, the Financial Industry Regulatory Authority (FINRA) issued a Regulatory Notice soliciting comments on a rule proposal designed to enhance oversight of broker-dealers' "back-office" operations by expanding registration requirements to individuals engaging in, or supervising, activities related to sales and trading support, and handling of customer assets. The Regulatory Notice will require which of the following persons to register with FINRA as an Operations Professional:

   I. Persons with the authority or discretion to commit the firm's capital in direct furtherance of the covered functions or to commit the firm to any contract or agreement (written or oral) in direct furtherance of the covered functions.
   II. Persons with access to the covered functions policies and procedures.
   III. Senior management with responsibility over the covered functions.
   IV. Supervisors, managers or other persons responsible for approving or authorizing work in direct furtherance of the covered functions, including work of other persons in the covered functions.

   A. I and II
   B. II, III, and IV
   C. I, III, and IV
   D. I, II, III and IV

2. On May 26, 2010, the Financial Industry Regulatory Authority (FINRA) issued a Regulatory Notice soliciting comments on a rule proposal designed to enhance oversight of broker-dealers' "back-office" operations by expanding registration requirements to individuals engaging in, or supervising, activities related to sales and trading support, and handling of customer assets. Which of the following functions or activities if performed by an individual, would require the individual to register as an Operations Professional?

   I. Trade confirmation, account statements, settlement, and margin.
   II. Collection, maintenance, re-investment (i.e., sweeps) and disbursement of funds.
   III. Development and approval of pricing models used for valuations.
   IV. Financial regulatory reporting.

   A. I, II, and III
   B. II and IV
   C. I, II, and IV
   D. I, II, III, and IV

3. On May 6, 2010, SEC Chairman Mary L. Schapiro gave the keynote address on the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 annual seminar. The main points of her address focused on transparency, fairness, and implementation.

   A. True
   B. False

FORUM QUIZ

4. On April 16, 2010, SEC Commissioner Luis A. Aguilar spoke at the ABA Systemic Risk Panel in New York City. In his speech Commissioner Aguilar indicated that is clear that insufficient and ineffective oversight, rather than over-regulation, facilitated the current financial crisis. He further stated that regulators lacked the will, knowledge and resources to respond appropriately to rapid financial innovation and market expansion. When the regulatory structure and those who operate it are so seriously hindered, as we have experienced, systemic risk escalates.

   A. True
   B. False

5. On May 11, 2010, SEC Director, Division of Investment Management Andrew J. Donohue spoke to the Massachusetts Society of CPAs. Director Donohue spoke about some of the initiatives in the SEC's Division of Investment Management, particularly some of the matters they are working on that may have accounting implications. Two of the current issues that pose certain challenges, particularly with respect to the transparency of fund investments and their financial disclosures that the SEC is working on are ____________ and _________________.

   A. Private Investments and Auction Rate Securities
   B. Money Funds and Auction Rate Securities
   C. Private Investments and Regulation S-X
   D. Money Funds and Investment Companies

6. On May 11, 2010, Commodity Futures Trading Commission Chairman Gary Gensler announced the formation of a joint committee with the SEC that will address emerging regulatory issues.

   A. True
   B. False

7. A bank trustee may loan trust funds to a bank director provided:

   A. a court order is received to override the prohibition.
   B. all beneficiaries give consent to waive the conflict of interest.
   C. Neither A nor B; such a transaction is a felony and never permissible.

8. A bank acting in a fiduciary capacity must meet the same conflict waiver requirements for its agency relationships as for its trustee relationships.

   A. True
   B. False

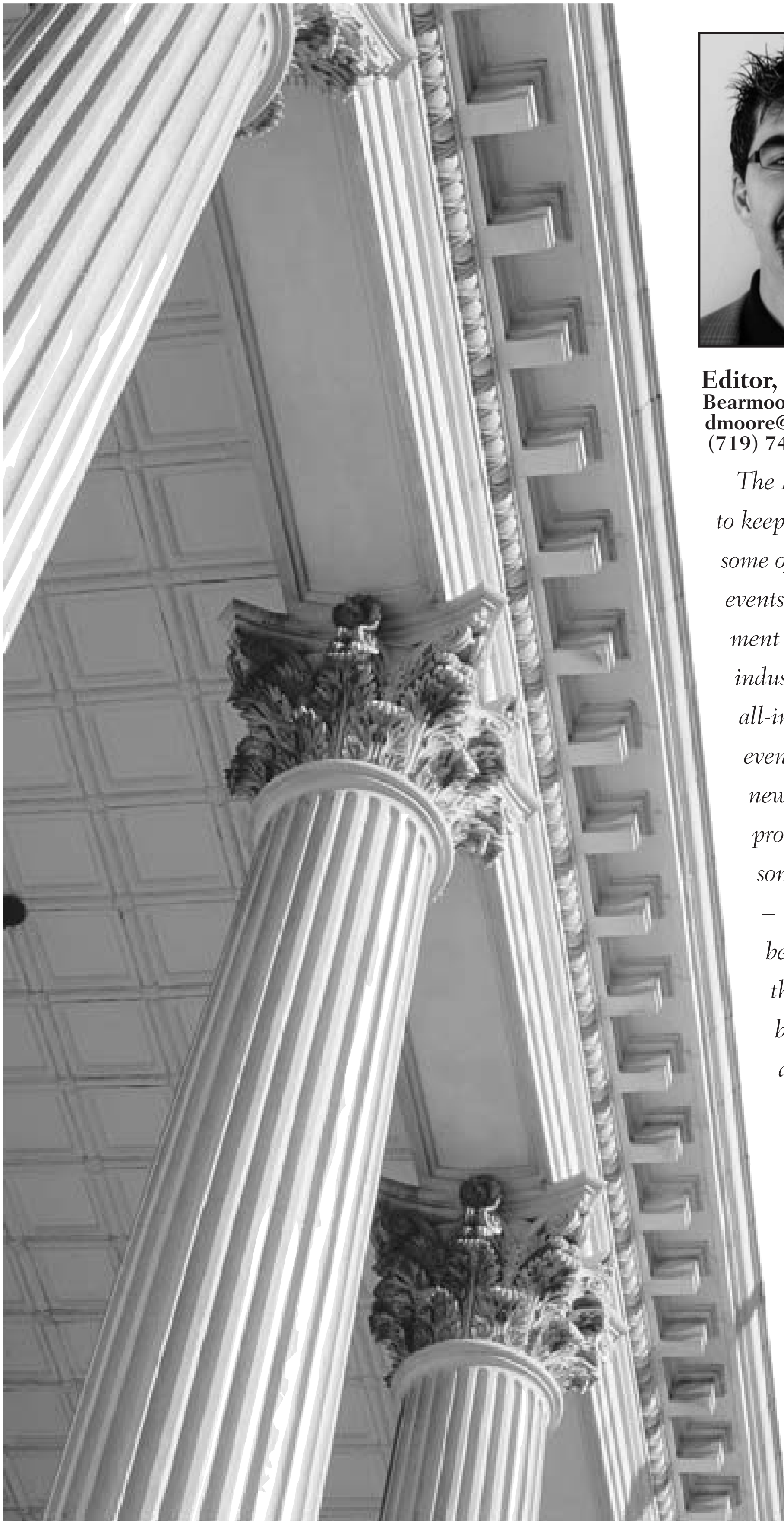
9. A corporate trustee is permitted to invest in affiliated mutual funds where an RIA affiliate may also be the investment advisor to the funds. This is allowed in ___ states.

   A. all
   B. some
   C. Neither A nor B; no states allow this activity

10. Under a fiduciary's duty to protect trust property, it is never permissible to engage an outside custodian to secure and preserve an asset.

   A. True
   B. False

REGULATORY UPDATE



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The Regulatory Update is designed to keep FIRMA members abreast of some of the important issues and events occurring in the trust, investment and financial services industry. It is not meant to be an all-inclusive list of issues and events occurring since the last newsletter update, but rather to provide detailed summaries of some of the most important ones – those the regulatory editor believes should be brought to the reader's attention. While we believe the subjects addressed are accurate, they should not be relied upon or construed as legal advice with regard to any specific matter. In addition, the information contained in this update is based upon the editor's interpretation and are not the opinions (official or unofficial) of the editor's employers.

REGULATORY UPDATE

***Editor's Note**: In this edition of the Regulatory Update I outline FINRA's Regulatory Notice 10-25 on the registration and qualification requirements of operations personnel. In addition I discuss the FINRA news release specific to supervisory failures surrounding acting as a trustee for cemetery trusts. Also, since we continue to be in a period of increased regulatory pressure, I have provided various speeches by SEC authorities that provide insight on current and future regulatory matters. Also I provide the announcement on the creation of Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues. Finally I outline EBSA's news release announcing the new E-signature Option for Forms 5500 and 5500-SF electronic filing. Should you have specific items you would like to be presented or discussed in the Regulatory Update, please send your requests to the attention of the FIRMA FORUM Editor, or myself.*

FINRA: Regulatory Notice 10-25; Registration and Qualification Requirements for Certain Operations Personnel

Background

On May 26, 2010, the Financial Industry Regulatory Authority (FINRA) issued a Regulatory Notice soliciting comments on a rule proposal designed to enhance oversight of broker-dealers' "back-office" operations by expanding registration requirements to individuals engaging in, or supervising, activities related to sales and trading support, and handling of customer assets.

Traditionally, FINRA's long-standing registration requirements have applied to individuals who provide advice to customers and effect securities transactions, such as brokers, investment bankers and traders. The new proposal would extend registration, testing and continuing education beyond the frontline sales force to certain operations staff who support broker-dealers' businesses. These employees perform an integral role inside the firms, and their actions can have meaningful connections to the safety of customer funds, accounts and transactions, and the overall integrity of firm books and records.

Firm employees who may be required to register under the new proposal include individuals responsible for the development and approval of valuation models; employees who manage trade confirmations, account statements, trade settlement and margin; or employees who oversee stock loan/securities lending, prime brokerage, receipt and delivery of securities, and/or financial regulatory reporting.

The proposal would provide reasonable assurance that these individuals understand their professional responsibilities, including key regulatory and control themes, as well as the importance of identifying and escalating red flags that may harm a firm, its customers, or the integrity of the marketplace or the public. The Securities and Exchange Commission (SEC) has previously indicated its support for the establishment of a qualification examination for back-office staff to heighten awareness of operating in a regulated environment and to demonstrate a basic understanding of the securities industry.

Testing for the new registration category would be composed of three segments: professional conduct and ethics, essential product and market knowledge, and knowledge associated with operational activities. The examination would test for general securities industry knowledge and awareness of the fact that the securities industry is heavily regulated. The continuing education components associated with the new registration category would provide competency training specific to the work performed by operations staff that support broker-dealer's business.

The proposal includes an exception for back-office employees who currently maintain certain other FINRA registrations or have maintained one during the two years immediately prior to registering as an operations professional.

Before becoming effective, a proposed rule change must be approved by the SEC.

Information

Given the growing complexity of the financial services industry and the importance of services provided by a firm's so-called "back-office" personnel, FINRA has concerns about the potential for regulatory gaps in the area of licensing and education requirements for individuals performing operations functions. Historically, federal and state law and self-regulatory organization rules, including NASD Rules 1021 and 1031, have required that individuals engaged in or supervising the securities or investment banking business of a member firm be qualified and registered persons. These requirements generally have applied to, among others, individuals with customer contact providing advice (sales persons and investment bankers) or effecting securities transactions (traders), and their supervisors. However, unregistered individuals who perform operations functions within a member firm also play an integral role in the business of the firm, and their activities often have a meaningful connection to client funds, accounts and transactions.

FINRA believes that licensing and education requirements for certain operations personnel are needed to help ensure that investor protection mechanisms are in place in all areas of a member firm's business that could harm a customer, a firm, the integrity of the marketplace or the public. Accordingly, FINRA proposes expanding its registration requirements to include as qualified and registered persons certain individuals who are engaged in, or supervising, activities relating to sales and trading support and the handling of customer assets (Operations Professionals) to enhance the regulatory structure surrounding a firm's back-office operations.

Depth of Personnel Included in the New Registration Category: Generally, the proposed registration category for Operations Professionals is aimed at capturing those persons with decision-making and/or oversight authority in direct furtherance of the covered operations functions, which are described in detail below (the covered functions). Persons subject to the new registration category generally are those persons who are directly responsible for overseeing that tasks within the covered functions are performed correctly in accordance with industry rules, firm protocols, policies and procedures, and who are charged with protecting the functional and control integrity of the covered functions for the firm.

More specifically, the following persons would be required to register with FINRA as an Operations Professional (collectively, covered persons):

(1) Senior management with responsibility over the covered functions;

(2) Supervisors, managers or other persons responsible for approving or authorizing work in direct furtherance of the covered functions, including work of other persons in the covered functions;

(3) Persons with the authority or discretion to commit the firm's capital in direct furtherance of the covered functions or to commit the firm to any contract or agreement (written or oral) in direct furtherance of the covered functions (including, e.g., a person who has the discretion to commit the firm to any contract or agreement involving securities lending or borrowing activities).

The requirements would not apply to persons who perform a covered function, but whose responsibilities are below these three specified levels, or persons who perform a function ancillary to a covered function or whose function is to serve a role that can be viewed as supportive of, or advisory to, the performance of a covered function, such as internal audit, legal or compliance personnel. Also, the requirements would not apply to persons who are engaged solely in clerical or ministerial activities in any of the covered functions.

Importantly, those persons subject to the new Operations Professional registration category would be considered associated persons of a firm irrespective of their employing entity and would be subject to all FINRA rules applicable to associated persons and/or registered persons. To implement this proposal, FINRA is proposing amendments to proposed FINRA Rule 1230 (Registration Categories) to add a new representative registration category for Operations Professionals. Also, in light of the fact that the Operations Professional registration category would encompass individuals engaged in or supervising stock loan/securities lending activities, the proposed registration categories for a "Securities Lending Representative" and a "Securities Lending Supervisor" would be eliminated.

Functions for Inclusion in the New Registration Category: The three categories of persons identified above that conduct activities or functions for the firm in one or more of the following covered functions would be required to register as an Operations Professional:

- Development and approval of pricing models used for valuations;
- Trade confirmation, account statements, settlement, margin;
- Stock loan/securities lending;
- Prime brokerage (services to other broker-dealers and financial institutions);
- Client on-boarding (customer account data and document maintenance);
- Capturing of business requirements for sales and trading systems and any other systems related to the covered functions, and validation that these systems meet such business requirements;
- With respect to the covered functions, defining and approving business security requirements and policies for information technology (including, but not limited to, systems and data);
- Defining information entitlement policy in connection with the covered functions;

- Financial Controller (including general ledger);
- Collection, maintenance, re-investment (i.e., sweeps) and disbursement of funds;
- Bank, custody, depository and firm account management and reconciliation;
- Segregation, possession and control, fail control, buy ins;
- Receipt and delivery of securities and funds, account transfers;
- Financial regulatory reporting; and
- Posting entries to the books and records of a firm in connection with the covered functions.

Operations Professional Qualification Examination: FINRA proposes the establishment of a new qualification examination for Operations Professionals that would provide reasonable assurance that such individuals understand their professional responsibilities, including key regulatory and control themes, as well as the importance of identifying and escalating red flags that may harm a firm, its customers, the integrity of the marketplace or the public. The SEC staff has previously indicated its support for the establishment of a qualification examination for covered persons to heighten their awareness of operating in a regulated environment and to demonstrate a basic understanding of the securities industry.

In general, given the diversity of functions performed by covered persons, FINRA proposes the development of a single principles-based qualification examination with a regulatory focus to test for a broad understanding of a broker-dealer's business at a basic level; a basic understanding of the operations functions that support a broker-dealer's business; and the regulations designed to achieve investor protection and market integrity that drive the operations processes and procedures conducted at a broker-dealer. Any individual whose activities go beyond those proposed for the Operations Professional registration category would be required to separately qualify and register in the appropriate category or categories of registration attendant to such activities.

The proposed Operations Professional qualification examination is not intended to be a competency examination, but would test for general securities industry knowledge with a regulatory focus to alert such persons that they are functioning in a heavily regulated industry. The continuing education components associated with the Operations Professional registration category would provide competency training specific to the covered functions.

The breadth and depth of coverage of the qualification examination would be determined through the use of testing industry standards used to develop examinations, and would include input and advice from covered persons active in the securities industry.

The following are the three key content themes of the new Operations Professional qualification examination:

- **Professional Conduct and Ethical Considerations:** This section of the examination would assess a candidate's core knowledge addressed on other FINRA examinations that is appropriate for the Operations Professional. The questions in this section would assess knowledge of what are considered serious violations of securities industry rules. This category would include ethics-based questions that address issues such as data integrity, escalation of regulatory red flags and separation of duties.
- **Essential Product and Market Knowledge for an Operations Professional:** This section of the examination would assess a candidate's basic product and market knowledge, including definitions and characteristics of major product categories (i.e., equities, debt, packaged securities, options and markets). The Operations Professional would not be expected to know the same level of detail about the products and markets as a product specialist or a representative selling products to customers.
- **Knowledge Associated With Operations Activities:** This section of the examination would assess a candidate's broad-based knowledge regarding the covered functions outlined above that support a broker-dealer's business, and the underlying rules that drive the processes associated with these activities (*i.e.,* customer account set-up and transfers, recordkeeping requirements, rules associated with the protection of customer assets and transaction processing, uniform practices associated with making good delivery of securities, making payments for securities and meeting settlement requirements, credit and margin rules, and how to obtain supervisory approval for any of the above).

Exception to Operations Professional Examination Requirement: FINRA is proposing an exception to the Operations Professional qualification examination requirement for persons who currently hold certain registrations (each an eligible registration) or have held one during the two years immediately prior to registering as an Operations Professional. The proposed exception also would apply to persons who do not hold an eligible registration, but prefer an alternative to taking the Operations Professional examination. Such persons would be permitted to register in an eligible registration category (subject to passing the corresponding qualification examination or obtaining a waiver) and use such registration to qualify for Operations Professional registration.

A person who wishes to obtain Operations Professional registration under the proposed exception would not be automatically waived-in, but would have to opt-in by requesting Operations Professional registration via Form U4 (the Uniform Application for Securities Industry Registration or Transfer) in the Central Registration Depository (CRD®). If there are no other deficiencies (funds, fingerprints, etc.), the Operations Professional registration would be approved automatically at the time such request is made. FINRA would not assess a separate registration fee for persons relying on the proposed exception to register as Operations Professionals. FINRA conducted a review of the content outlines for each qualification examination it recognizes and identified examinations with broad content coverage that would be eligible for an exception to the Operations Professional examination requirement.

Accordingly, persons that hold the following representative level registration categories, or who have held such registration categories within the two years immediately prior to registering as an Operations Professional, would be qualified to register as an Operations Professional without passing the Operations Professional qualification examination:

- Investment Company Products/Variable Contracts Representative (Series 6)
- General Securities Representative (Series 7)
- United Kingdom Securities Representative (Series 17) or Canada Securities Representative (Series 37 or 38)

Additionally, persons who hold (or have held) certain principal-level registration categories would be qualified to register as an Operations Professional without passing the Operations Professional examination. Most principal-level qualification examinations have a prerequisite examination requirement that is satisfied with one of the representative qualification examinations listed above; however, FINRA also proposes to include principal-level qualification examinations that do not have a prerequisite, or that have a prerequisite that can be met with a qualification examination not on the above list (e.g., Series 62), because it is likely that such principals are familiar with the content to be covered in the Operations Professional qualification examination as a result of the requirements of their positions.

Accordingly, persons who hold the following principal-level registration categories, or who have held such registration categories within the two years immediately prior to registering as an Operations Professional, would be qualified to register as an Operations Professional without passing the Operations Professional qualification examination:

- Registered Options Principal (Series 4)
- General Securities Sales Supervisor (Series 9/10)
- Compliance Officer (Series 14)
- Supervisory Analyst (Series 16)
- General Securities Principal – Sales Supervisor (Series 23)
- General Securities Principal (Series 24)
- Investment Company Products/Variable Products Principal (Series 26)
- Financial and Operations Principal (Series 27)
- Introducing Broker/Dealer Financial and Operations Principal (Series 28)
- Municipal Fund Securities Limited Principal (Series 51)
- Municipal Securities Principal (Series 53)

The proposed exception would not apply to persons whose eligible registrations have been revoked or terminated pursuant to FINRA Rule 8310 (Sanctions for Violations of the Rules) within the two years immediately prior to registering as an Operations Professional.

FINRA notes that operations personnel who would be subject to the Operations Professional registration requirements are generally acting in a supervisory position, so many persons will already hold one of the eligible registrations that would qualify for the exception to the Operations Professional examination requirement. As noted above, entry-level operations personnel would not typically be subject to the proposed requirements for Operations Professionals.

Continuing Education Requirements for Operations Professionals: FINRA would require that individuals registered as Operations Professionals be subject to FINRA's Regulatory Element and Firm Element continuing education requirements as set forth in NASD Rule 1120 (Continuing Education Requirements). The continuing education elements for this registration category would provide learning materials appropriate for Operations Professionals, given the breadth of functions that are covered by this registration requirement.

The Regulatory Element program for Operations Professionals would provide instruction for Operations Professionals to:

(1) Maintain and improve understanding of the regulatory and ethical aspects associated with the covered functions;

(2) Identify suspicious activities and/or red flags that could harm a customer, a firm, issuers of securities or the integrity of the marketplace;

(3) Maintain and improve knowledge and understanding of the covered functions; and

(4) Assist the Operations Professionals in keeping up with changes in the industry and regulations that impact their work.

Operations Professionals would be required to complete scenario-based modules based on the key content themes of the Operations Professional qualification examination, as described above. The breadth and depth of coverage of the modules would be determined through the use of existing industry standards currently used to develop continuing education content and would include input and advice from operations professionals active in the securities industry. Individuals would be expected to complete the Regulatory Element continuing education requirement two years after passing the qualification examination and then every three years thereafter. FINRA expects that the continuing education content for Operations Professionals would be available two years after the launch of the qualification examination.

Individuals who avail themselves of the proposed exception to the Operations Professional qualification examination requirement with an eligible registration would be subject to the Regulatory Element program appropriate for such other registration category. For example, a person who registers as an Operations Professional by holding a General Securities Representative registration under the exception would be subject to the S101 continuing education program.

Operations Professionals would also be subject to Firm Element training. To implement this change, FINRA would expand NASD Rule 1120(b) to include Operations Professionals in the definition of "covered registered persons," and to require that firms deliver Firm Element training to Operations Professionals subject to the new registration and qualification requirements.

Transition Period and Implementation Date:

1. Persons Acting as Operations Professionals as of the Effective Date of the New Registration Requirement

FINRA is proposing a six- to nine-month transition period for existing personnel that meet the depth of personnel criteria and are engaged in the covered functions as of the effective date of the proposed registration category. During this six- to nine-month period (which would begin on the date the proposed registration category takes effect) covered persons would be required to register with FINRA as Operations Professionals. FINRA believes that a six- to nine-month transition period will provide firms with an opportunity to identify persons who would be subject to the Operations Professional requirements, and provide such covered persons an opportunity to register as an Operations Professional by doing one of the following, as applicable:

(1) Requesting Operations Professional registration via Form U4 in CRD and passing the Operations Professional qualification examination;

(2) Requesting Operations Professional registration via Form U4 in CRD pursuant to the proposed exception, based on their holding, or having held within the past two years, an eligible registration; or

(3) Registering with FINRA in one of the eligible registrations and, pursuant to the proposed exception requesting Operations Professional registration via Form U4 in CRD

2. Persons Who Begin Work as Operations Professionals Following the Effective

Date of the New Registration Requirement

The six- to nine-month transition period would not apply to persons who meet the depth of coverage criteria and begin work in the covered functions following the effective date of the proposed registration category (i.e., new hires or existing associated persons who transition into the covered functions). Such persons would be required to register as an Operations Professional prior to engaging in any of the activities that would qualify them as covered persons, regardless of whether they begin work during the transition period or after it expires, and would be permitted to register as described above.

FINRA – News Release: Citigroup Pays $1.5 Million for Supervisory Failures Related to Elaborate Scheme to Misappropriate Millions in Trust Funds Belonging to Cemeteries Located in Michigan and Tennessee

Background

The Financial Industry Regulatory Authority (FINRA) announced on May 26, 2010, that it has imposed a monetary sanction of $1.5 million against Citigroup Global Markets Inc. for supervisory violations relating to its handling of trust funds belonging to cemeteries in Michigan and Tennessee. The sanction represents a $750,000 fine and disgorgement of $750,000 in commissions, which is being returned to the cemetery trusts as partial restitution.

"Firms have a duty to protect customer funds by taking prompt and meaningful action when they encounter indications of possible fraud or misappropriation," said James S. Shorris, FINRA Executive Vice President and Executive Director of Enforcement. "That duty is particularly critical when firms handle trust funds where the beneficiaries may be unsophisticated investors who are unaware of how the funds are being handled."

Information

Citigroup consented to findings that, from September 2004 through October 2006, Citigroup broker Mark Singer and two of his customers were involved in a scheme to misappropriate an amount alleged in various legal actions to be over $60 million in cemetery trust funds. One of Singer's customers, Clayton Smart, is currently facing criminal charges arising from the scheme in Tennessee and in Michigan. Singer's criminal trial in Tennessee recently ended in a mistrial. He still faces criminal charges in Indiana. Smart and the second customer, Craig Bush, have been named in civil litigation arising from the scheme.

Singer's two customers, Smart and Bush, were successive owners of a group of Michigan cemeteries from which funds were believed to be stolen. In August 2004, Smart purchased the cemeteries from Bush using trust funds that had been improperly transferred from the Michigan cemeteries themselves to a company that Smart owned. Soon afterwards, Smart used additional trust funds to buy cemeteries and funeral homes in Tennessee.

FINRA found that a Citigroup branch manager had recruited Singer from another broker-dealer, where the scheme originated. When Singer began working for Citigroup in September 2004, he brought nearly all of his customer accounts with him, including the cemetery trust accounts and other accounts belonging to Bush. Singer assisted Bush and Smart in opening numerous Citigroup accounts in their own names, as well as in the names of corporate entities they owned or controlled. Singer helped Bush and Smart deposit cemetery trust funds into some of these accounts and then effect improper transfers to third parties, sometimes using conduit accounts to mask the transactions. Some of the fund transfers were disguised as fictitious investments made on behalf of the cemeteries.

FINRA's investigation showed that over a period of more than two years, Citigroup failed to reasonably supervise the handling of these accounts by inadequately responding to a succession of "red flags" – failures that permitted the scheme to continue undetected until October 2006.

The red flag events began in September 2004, shortly after Singer began working at Citigroup. Singer's previous employing broker-dealer warned Citigroup about irregular movement of funds involving accounts connected to the Michigan cemetery trusts – activity that occurred before Bush moved his accounts to Citigroup and while Bush was still owner of the Michigan cemeteries. After receipt of this information, however, FINRA found that Citigroup's follow-up of the activity in Bush's accounts was superficial and incomplete.

By November 2004, Citigroup's management became aware of rapid movement of funds involving Citigroup accounts associated with Bush and Smart – including unusual transfers of cemetery trust funds to accounts opened in the names of third parties – but failed to conduct an adequate inquiry into the matter. In February 2005, Citigroup received information indicating possible misrepresentations by Smart regarding his acquisition of hedge fund investments belonging to the Michigan cemetery trusts, which Smart used as collateral for a personal $24 million line of credit from Citigroup Private Bank. Again, Citigroup failed to conduct an adequate inquiry.

Finally, in May 2006, Citigroup received a whistleblower letter – from the principal of a company acting as a third-party trustee for the cemeteries – alleging misconduct by Singer in connection with the handling of the cemetery trusts. Among other things, this letter alleged Singer's involvement with unauthorized transfers of cemetery trust funds, as well as Singer's use of his personal email address to conduct business with the whistleblower, in an apparent attempt to bypass the firm's email monitoring system. Despite the seriousness of these allegations, Citigroup failed to enhance supervision of Singer or restrict his activities.

In settling these matters, Citigroup neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

SEC: Speech by SEC Chairman Mary L. Schapiro at the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 Annual Seminar

Background

On May 6, 2010, SEC Chairman Mary L. Schapiro gave the keynote address on the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 annual seminar. She stated that our nation's success relies in large part on the fairness and efficiency of our capital markets. It is where manufacturers raise capital to create new jobs, where municipalities raise funds to build new schools, and where businesses raise money to conduct research and develop technology. The main points of her address focused on transparency, fairness, and enforcement. Below are her comments on these three topics.

Transparency: When the securities laws of the 1930s were passed, the products were simpler. There were stocks and there were bonds. The information was easy – or at least easier – to digest. Most investors could appreciate the risks inherent in each transaction. And, as a result of the federal securities laws, most transactions were public. This allowed the market to price trades rationally, and market participants to see trends and spot risk.

Since then, trading and the products being traded have become far more complex – often in ways that provide less transparency to investors. So, for instance, the inability of individual investors or even so-called experts, to accurately judge the assets underlying asset-backed securities led to massive losses which helped to put the current crisis in motion.

And, for another example of the ruin caused by opacity, we can look at trading in over-the-counter derivatives that magnified the crisis dramatically once it began.

Asset-Backed Securities: As you well know, asset-backed securities are created when loans or other assets are bundled together to create a security, and sold to investors. There are, of course, many ways to build on the relatively simple ABS base – dividing the bundles into different tranches with different levels of risk and different degrees of returns; rebundling existing securities into other, more complex CDOs; creating synthetic CDOs, and so on.

Understanding the risk in any of these products demands an accurate analysis of the risk of the original individual assets underlying them all. Yet investors in recent years have been unable to penetrate all of what makes up each ABS.

If investors could not appreciate the risks in the securities, then one culprit may have been a lack of transparency – or at least a lack of sufficiently accessible transparency.

That's why we recently proposed rules that would revise the disclosure and offering process in the ABS arena. Our proposals are intended to provide investors with more detailed and current information about these products and more time to make their investment decisions. For the first time, the information requirements would be extended to private offerings made in reliance on our safe harbors.

Under the rules, asset-backed securities issuers would be required to provide detailed data for each loan in the asset pool, both at the time of securitization and on an ongoing basis.

The loan-level data would cover items such as the terms and underwriting of the loan, credit information about the borrower, and characteristics of the property securing the loan. And, the information would be tagged and computer-readable so investors can synthesize large amounts of data about the underlying assets – and do it without having to rely on the sometimes flawed judgments of credit rating agencies.

At the same time, I believe we can do more to protect investors in this ABS market as well. So our proposed rules also seek to better align the interests of issuers and investors by creating a retention requirement for certain public offerings of asset backed securities.

No one may have envisioned the widespread growth of such things as ABS seven decades ago, but through an insistence on transparency and fairness, the framers of our securities laws created a regulatory regime that would be adaptable to whatever the future would hold.

OTC Derivatives: As with ABS, over-the-counter derivatives – at least as they exist today – were not even a glimmer in the eyes of securities regulators back in the 1930s.

But, by promoting transparency, the creators of our securities laws were embracing a principle that today most agree should apply to OTC derivatives.

Unfortunately, what those legislators probably didn't expect was for a subsequent law to be adopted creating a loophole for later generations of derivatives. Yet, that's exactly what the Commodity Futures Modernization Act of 2000 did.

Because over the counter derivatives trading lacked meaningful transparency, investors lacked the information needed to price derivatives accurately – bringing natural market corrections, and regulators could not appreciate the risks multiplying throughout the system.

As Congress considers financial reform, it has been our consistent refrain that the kind of transparency we have today in the corporate bond market, is essential to the successful oversight of the derivatives marketplace and to the ability of investors to knowledgeably engage in these transactions.

Fairness: Another of these original principles is fairness. To the extent possible, every investor should have the same opportunity to profit from his or her investment and to be assured that they are doing business with people and institutions that are qualified, supervised and playing by the rules. This is why, for example, the SEC imposes requirements for honest sales practices, disclosure of fees and expenses for mutual fund investments, and maintains a sharp focus in our enforcement program on a wide range of activities that have the potential to harm investors.

The fairness owed to investors cannot be compromised by complexity. Today, just as products are becoming more complex, so too is the structure of our markets.

No longer do we rely on people shouting on the exchange floors to transact business. Instead, we rely on computerized trading whose speed has accelerated from seconds to milliseconds to microseconds. And, for some that isn't fast enough.

Trading volume has expanded, and new trading centers have entered the markets and captured a significant share of volume. Liquidity is now dispersed among many different venues, and these venues offer a complex array of order types and trading services.

But, once again – just because technology is progressing and trading platforms have proliferated – fairness must remain the underpinning of the market.

So we have been engaged in a serious review of the equity market structure. All in an effort to ensure that the markets remain fair for all investors – and to prevent the emergence of a two-tier system that favors only an elite few.

Already, our review has resulted in several proposed rules intended primarily to preserve the integrity of longstanding market structure principles.

One such proposal would ban flash orders, which enable a person who has not publicly displayed a quote to see orders before the public is given an opportunity to trade with those orders.

Another proposal would strengthen transparency requirements for non-public trading interest, including dark pools that do not display quotations to the public.

And, a third proposal would bolster the risk management controls of broker-dealers that provide direct market access to their customers.

I also anticipate this spring that the Commission will consider staff recommendations to have the self-regulatory organizations develop and implement a consolidated audit trail that captures customer and order event information across markets.

Our market review additionally includes outreach to the industry and investors seeking comment on a broad range of issues – focused on high-frequency trading, co-locating of trading terminals, and markets that do not publicly display price quotations.

REGULATORY UPDATE

Our goal will be to assess how these changes in the market are affecting investors and to assure the principles of the last century are still alive and well today.

That is why we are asking hundreds of questions, including such fundamental ones as:

- How do we measure and assess market quality for long-term investors and have the metrics improved or worsened in recent years?
- Is the current highly-automated, high speed market structure fundamentally fair for all investors?
- What types of strategies are used by the proprietary trading firms loosely referred to as high frequency traders, and are these strategies beneficial or harmful for other investors?
- To what extent do the interests of short-term professional traders diverge from those of longer-term investors and what are the implications of that?

Further, next month, we will host a Market Structure Roundtable to delve deeper into the issues. In particular, I look forward to discussing the consequences of high-frequency trading for and the impact of undisplayed liquidity on long-term holders.

Finally, as you know better than anyone, market participation has grown dramatically in the last 20 years, especially as more people turn to tax-favored investments to save for college and secure their retirements. We have seen a steady stream of product and fee structure innovation in our markets, leaving many confused.

And one thing we can count on is that your firms will continue to create new products and funds in an effort to match risk and reward to individual needs. But, adherence to that principle of fairness is critical to investors' willingness to commit their capital to new products.

In an innovative market with new alternatives appearing every day, it's important that the people who turn to professionals for advice know what incentives exist beyond the client's needs, for the men and women influencing their investment decisions.

Right now, investment advisers, as fiduciaries, have an obligation to provide advice that is in an investor's best interest – and to avoid or disclose conflicts of interest. Broker-dealers, who earn transaction fees and sometimes incentives for guiding decisions towards one strategy or another, do not currently have to meet this standard, although they are subject to a more comprehensive regulatory regime.

I believe that broker-dealers and investment advisers providing the same services, especially to retail investors, should meet that same high fiduciary standard. This is an issue that I hope will be addressed in regulatory reform legislation and one that is fully consonant with the principle of fairness that helped guide the development of the securities laws.

In this vein, my staff is preparing to present to the full Commission a recommendation regarding adoption of Form ADV, Part 2 – the primary disclosure document for advisory clients. We are looking to move past the 1960s check-the-box, paper-based approach by requiring a plain English narrative discussion of an adviser's conflicts, compensation, business activities and disciplinary history.

The rule would also require disclosure of this information through the SEC's website, so that investors, regulators and the public at large have free and simple access to it.

And, finally, I have asked the staff to present a recommendation on 12b-1 fees for Commission consideration this year. In 2008, these fees totaled $12 billion, but many investors have little idea that they are being deducted from their mutual fund – or what they are paying for. We need to critically rethink how 12b-1 fees are used and whether they remain appropriate.

Enforcement: The third and final principle I want to briefly touch upon is enforcement. Since the SEC's birth, we have brought tens of thousands of enforcement actions – and they are a critically important component of oversight. I believe most industry professionals appreciate the value of and the need for transparency and fairness. And, I know that the prospect of suspensions, bars or penalties helps to reinforce the importance and centrality of those obligations.

But to me, enforcement actions are not just about righting a particular wrong, but sending a message that the SEC is watching.

In the wake of the financial crisis, we have brought a number of cases including those alleging accounting fraud at subprime lenders, misrepresentation of complex investments as appropriate for retail investors seeking safe investments, fraud in connection with CDO marketing materials, and misleading investors about exposure to subprime investments.

Our cases have included actions against firms from American Home to Countrywide; from New Century to State Street to J.P. Morgan. And, we are continuing to pursue cases related to the financial crisis with many ongoing investigations involving complex products across the range of market participants.

Additionally, we continue to bring significant cases in many important areas, including Ponzi schemes, offering frauds, municipal securities, unlawful pay-to-play activities, accounting fraud, and large-scale insider trading.

Last year, I provided Congress with a package of legislative proposals that would significantly improve our ability to protect investors. Most of these provisions were adopted by the House of Representatives with little controversy. Key elements would improve the SEC's ability to exercise its enforcement and examination authorities.

One would harmonize our authority to pursue aiders and abettors in all types of Commission actions. Another provision would provide for nationwide service of process in our federal court actions. And yet another would increase our ability to obtain important information from regulated entities. The Senate should consider including many of these provisions in the final legislation, and we have advocated strongly for that.

Conclusion

In the wake of the financial crisis it has become a cliché that regulators cannot keep up with innovators in a market as dynamic as finance. I don't think that's true. But I think that where we sometimes go wrong is in trying to react to and respond to every change or innovation, often before its significance is known – or after it has become too apparent.

Instead, we should be looking to the future by returning to proven principles of the past, like transparency and fairness – principles that empower investors to make rational decisions and give regulators the tools they need to prevent crises, without stifling growth.

SEC: Speech by Commissioner Luis A. Aguilar on Regulatory Reform That Optimizes the Regulation of Systemic Risk

Background

On April 16, 2010, SEC Commissioner Luis A. Aguilar spoke at the ABA Systemic Risk Panel in New York City. Below are excerpts from his speech regarding the topic of regulatory reform that optimizes the oversight and regulation of systemic risk.

Information

As those in this room know, the essential role of the financial services sector is to facilitate the allocation of capital to economically productive uses. There has been a clear failure in this regard, with widespread mispricing of assets, trillions in losses, and, perhaps most disheartening, painful levels of unemployment and underemployment – together with an unprecedented concentration of wealth at the top. Moreover, putting aside acknowledged gaps in legislation, regulators facilitated this failure by choosing not to use authority within their power and mistakenly believing that private parties could police themselves far better than any regulator could.

Today, we live in a world where a significant amount of the profits and financial market activity arises from leverage-financed bets on stock prices and credit derivatives, with insufficient concern for the fundamentals of the underlying companies. This contrast between Wall Street and Main Street - between the financial sector and the real economy - has ushered in an era of casino capitalism with severe ramifications that continue to reverberate through our capital markets. It is a situation in dire need of reform. Martin Wolf, the chief economics commentator for the Financial Times, stated that this casino capitalism "represents the triumph of the trader in assets over the long-term producer."

As we discuss the way forward, I am going to concentrate my remarks on the following:

- ♦ The definition of systemic risk;
- ♦ The relationship between primary regulators and any systemic regulator; and
- ♦ The danger of regulatory discretion becoming a substitute for regulatory reform.

The Definition of Systemic Risk: Clearly, the need to both define and manage systemic risk is at the heart of regulatory reform. Over the course of the debate, the term "systemic risk" has been mentioned so often it is easy to conclude that there is a universal understanding of the term, but this is not the case.

This is a problem the world over. As the Commission liaison to the Council of Securities Regulators of the Americas (COSRA), last week I participated in our bi-annual meeting, and we spent a significant amount of time discussing systemic risk and how it should be defined and regulated. There was no obvious consensus. Additionally, in a report prepared in October 2009 for the G-20 and Central Bank Governors, it was found that twenty-eight countries did not have a legal or formal definition of what constitutes systemic importance.

Other than a general understanding that systemic risk is risk that has widespread impact, there seems to be little agreement of the types of events, or the nature of activities, that could actually cause the kind of market meltdown that a systemic risk regulator would be tasked with monitoring and preventing. For example, some countries focus on the impact of potentially systemic institutions, markets, or instruments on the financial system, while other countries consider the impact on the real economy, as opposed to the financial sector, to be the key consideration. The possible reasons for these differences are difficult to discern.

Regulators are not the only ones focused on the concept of systemic risk, we are seeing it in other contexts, including shareholder proposals.

In fact, SEC staff recently denied a company's request to exclude a shareholder proposal from its proxy materials because it focused on a significant policy issue – systemic financial risk. The specific proposal in question asked for a report of the company's collateral policies for over-the-counter derivatives trades and its procedures to ensure that collateral is maintained in segregated accounts and is not re-hypothecated. The proposal indicated that it was intended to allow shareholders to adequately assess the company's sustainability and overall risk, in order to avoid future financial collapses. Given the role of collaterization and re-hypothecation practices in managing systemic financial risk, as well as the company's significant derivatives activities, staff was unable to agree with the company that this particular proposal could be excluded as relating to a matter of ordinary business. Rather, staff concluded that the proposal focused on a significant policy issue – systemic financial risk.

From shareholders to people around the world, there is widespread agreement that the global financial system has demonstrated vulnerability to systemic risk. However, how one defines systemic risk matters in terms of the resulting regulatory structure. It seems that identifying systemic risk is akin to the often referenced statement by Justice Potter Stewart about obscenity: "I know it when I see it." This lack of a common understanding is important because how you define systemic risk directly influences your ideas about how the financial regulatory system should be structured and operated.

Preserve Market Function Not Institution: Many think that the regulation of systemic risk should be primarily focused on preserving the viability of institutions that are "too big to fail" because of their size, interconnectedness, or risk concentration. But this view of systemic risk can result in a financial regulatory model that focuses too much on institutions, not enough on investors, and it positions a government regulator to pick winners and losers among companies at the expense of investors and market certainty – as we saw during the events of September 2008.

Another view is that systemic risk regulation should focus on ensuring the continuation of systemically important market functions, and on investor protections. This can be accomplished by regulation that affirmatively prevents institutions from growing too big to fail in the first place. This view requires that regulation go beyond setting prudential standards.

The process must also involve identifying the systemically important market functions that an entity provides and work to isolate these functions within the entity. The objective would be to ensure that the functions can be separately maintained should other parts of the entity fail. The regulation could also provide for cross-entity relationships to allow one or more entities to step in and continue the functions seamlessly. For example, let's think about the SEC regulation of the national securities market system: if the NYSE-Arca systems were to fail, the SEC has designed our market system so that NASDAQ would pick up the important market functions.

I believe systemic risk regulation should focus on the continuation of market functions, and not necessarily on the preservation of institutions.

Relationship between SEC and Systemic Risk Regulator: Another aspect of addressing systemic risk is defining the relationship between a systemic risk regulator and the primary regulators. If systemic risk regulation is truly focusing on the overarching risk concerns, the systemic risk regulator should be viewed as a supplement to – rather than a replacement for – the primary regulator, such as the SEC.

It is not hard to imagine a world where the mission of a systemic risk regulator is in direct conflict with that of the primary regulator. For example, envision a situation where a primary regulator is "encouraged" to drop an enforcement action because it may shake public confidence in a "too big to fail" firm. In such circumstances, a systemic risk regulator could crowd out the specialized regulatory agencies and, even more importantly, undercut their mission.

With these potential conflicts, it then becomes that much more important to analyze the current systemic risk regulation regime being contemplated by Congress and to ask the hard questions about how it will work. Currently, the legislation that was approved in the House of Representatives authorizes a new Financial Services Oversight Council (FSOC) with the task of monitoring systemic risk. This Council will be chaired by the Treasury Secretary, and the Federal Reserve Board (Fed) will operate as its agent. The Fed would be empowered to impose additional requirements on institutions and activities deemed systemically important.

The proposed legislation that has advanced from the Senate Banking Committee has a similar structure with a few differences. It also proposes a Council, the Financial Stability Oversight Council (Oversight Council) chaired by the Treasury Secretary, and charges it with monitoring and overseeing systemic risk. The Oversight Council, however, would be required to consult only with primary financial regulators rather than with both the Fed and such agencies as under the House bill. Non-bank entities would be subject to Fed oversight only if the Oversight Council made that determination by a super-majority vote.

Two crucial similarities between the House legislation and the proposed Senate bill are that the proposed systemic risk Council is chaired by the Secretary of the Treasury and would have wide-ranging authority to identify systemically important firms and impose enhanced prudential standards, and that the Council would rely heavily on the regulatory decisions and activities of the Fed.

As Congress considers authorizing this new regime, there must be consideration of its ramifications for the entire regulatory system. First, for example, there will be inherent tensions and conflicts that arise when one regulator has combined responsibility over monetary policy, a vested interest in the safety and soundness of particular institutions, and powers to address systemic risk. There is a danger that any organization with a focus on a particular industry and very broad powers could favor that sector to the potential detriment of others.

A second concern would be that any new legislation will take financial regulators that are independent entities and subject them to the leadership of a political figure – in this instance the Treasury Secretary. The independence of most financial regulators has benefited the financial system and the American public, and it should be maintained. If a systemic risk Council is created, we need to ask what safeguards will be put in place to insure that the independence of the regulators and of their regulatory decisions will not be tainted. How can we safeguard from political considerations dominating the process?

Substituting Regulator Discretion for Regulatory Reform: Apart from the structure of the regulatory regime itself, it is important that investor protection and the fairness of our markets not depend solely on the discretion of regulators. It is important that any regulatory reform put laws on the books that create clear principles that can stand the test of time as cornerstones of a regulatory program.

It is well established that, prior to the financial crisis, regulators had abandoned vigorous governmental oversight and placed their faith in the ability of the markets to self-police and self-correct. Even as the credit crisis unfolded in early 2008, the prevailing view in the industry and among many agencies and government leaders was that too much regulation, rather than too little, was eroding the competiveness of the U.S. markets. In fact, the financial crisis has proven the opposite. It is clear that insufficient and ineffective oversight, rather than over-regulation, facilitated the crisis. As I have spoken about many times, beyond this misplaced faith in the markets, regulators lacked the will, knowledge and resources to respond appropriately to rapid financial innovation and market expansion. When the regulatory structure and those who operate it are so seriously hindered, as we have experienced, systemic risk escalates.

Thus, regulatory reform will not succeed if market participants are engaged in the exact same behavior as before, and regulators are simply encouraged to be more active. This regime would lack a principled core, and it is likely to encourage activity that promotes systemic risk rather than corral it. We do not want regulatory reform that creates, as the well-known financial journalist Steven Pearlstein said, "the kind of complexity, the opportunities for regulatory arbitrage and the lack of accountability that got us into this mess in the first place."

Statutory provisions should be written to affirmatively reduce or eliminate sources of systemic risk. Take, for example, the issue of capital requirements for financial firms. The House Bill authorizes regulators to enforce a simple mandatory leverage limit of 15 to 1, whereas the Senate bill leaves the decision to impose capital requirements to the discretion of regulators. The problem with discretionary authority, of course, is that you need to know when to use it, and you need to have the will to use it when appropriate. Financial journalist, Ezra Klein, recently wrote on this topic and advised that "the trick is building protections that work even when the people in charge don't realize that they're needed."

I agree with Thomas Hoenig, the President of the Federal Reserve Bank of Kansas, who stated that "Congress should mandate simple, easily understood and enforceable rules – rather than guidelines so regulators can restrain and rein in the financial firms." With clear rules in hand, regulators should then be given broad authority to customize these rules. Of course, the regulator should be required to make appropriate findings that the proposed changes are in the public interest and do not increase systemic risk. Given an unpredictable future, regulatory reform will be most effective if rules are straightforward and regulators are empowered to address future needs.

Let's face it – No matter how broad the reach of any new legislation, an army of lawyers will work to find loopholes and to structure products and relationships to fall within the gaps. Regulators must therefore operate from a set of principles and rules that will stand the test of time.

Conclusion

As I conclude, let me reiterate that the current chasm between Main Street and Wall Street must be closed. There need to be clear, enforceable rules of the road wherever possible. As Congress returns its attention to financial reform, I urge it to do so with investors and the American public foremost in mind. It is my hope that we can shift the dialogue from the discussion of how best to preserve "too big to fail" financial institutions to what is best for investors and to our long-term economic growth. Political leaders, market participants, regulators, and other interested parties have to remember that financial services exist to serve investors – and in turn, our economy. To that end, it's important that the focus on "too big to fail" doesn't ignore ordinary Americans by thinking of them as "too small to matter." Thank you.

SEC: Speech by Director Andrew J. Donahue to the Massachusetts Society of CPAs Investment Company InfoShare Program

On May 11, 2010, SEC Director, Division of Investment Management Andrew J. Donohue spoke to the Massachusetts Society of CPAs. Director Donohue spoke about some of our initiatives in the SEC's Division of Investment Management, particularly some of the matters they are working on that may have accounting implications. He stated that investors need appropriate and correct information to make informed decisions and that they need information in a form that is accessible and easy to use, as well as investor protections to instill their confidence and access to the markets through pooled assets – has been the driving force behind the Division's most recent initiatives in this area. Below is an excerpt from Director Donohue's presentation.

Information – Response to Market Events

Our initiatives in the Division of Investment Management are prompted by various circumstances, such as the need to address market changes and update the regulations. Others are prompted by market events and the activities by market participants. In the aftermath of the recent market turmoil, a few of the Division's major initiatives fall into this category.

Money Market Funds: In particular, since the beginning of the turmoil in 2007, a priority for the Division has been the regulation of money market funds. This has been a challenging period for the $3 trillion money market fund industry, encompassing the first "breaking of the buck" by a widely held money market fund and the unprecedented enactment of various liquidity facilities and other government programs to assist the funds. Perhaps the most significant challenge in the current market environment is that persistent, low interest rates have caused many money market fund advisers to waive a large portion of their fees to avoid yields from going negative for investors. I understand that this has caused some sponsors to exit the business entirely as they see their profits evaporate. However, money market funds continue to play a crucial role for our economy by acting as buyers of short-term paper from businesses and government entities. They also remain an extremely popular product with all types of investors, both retail and institutional.

With respect to the money market fund regulatory model, the challenge is to strike the right balance between improving the safety of money market funds and preserving the ability of money market funds to generate yield for their investors. In this regard, the actions that the Commission has taken are aimed at improving the ability of money market funds to withstand the financial stresses that they will inevitably experience.

These actions include the Commission's adoption in January of new rules governing money market funds. The rules require, among other things, that money market funds comply with new maturity standards that make them less vulnerable to market risks; and that they meet new daily and weekly liquidity standards so that they have a greater portion of their assets in liquid investments and be in a better position to pay redeeming investors under any market conditions. Also under the new rules, money fund managers have to stress test their portfolios under different scenarios, such as a sudden increase in interest rates or the default of issuers of securities held by the fund. Furthermore, money funds must disclose portfolio information to the public each month on their web sites. This disclosure will equip investors with information they can use to evaluate the risks of investing in particular funds. Finally, money funds must file more detailed portfolio reports each month with the Commission to help us oversee the funds. The information also will be available to the public on a 60-day delay and will help investors to see more detail about the risks that a fund may be taking with their money. In my view, the availability of the information also may cause fund managers to think more carefully about the decisions they make about the fund's investments.

The new rules represented strong action by the Commission to make money market funds a more transparent and safe investment. However, I believe these were only a first step in a continuing effort to improve the regulation of money market funds. More is yet to come. The financial crisis exposed certain systemic risks connected to money market funds - namely the susceptibility of the funds to runs in times of extreme market stress. The Commission has asked more fundamental questions about money market funds and their ability to maintain a stable net asset value of one dollar per share, and I expect to see a continuing policy discussion of these questions.

Advisers Act Custody Rule: Another initiative that followed market events was the Commission's adoption of changes to the rule governing an investment adviser's custody of client assets, which you heard a discussion about earlier. In adopting that rule, the Commission took important steps to provide greater protections to investors who entrust their assets to investment advisers. The rule followed a series of enforcement cases the Commission brought against advisers and broker-dealers alleging fraudulent conduct, including misappropriation and other misuse of investor assets. I wanted to briefly add to the discussion of this rule, that I encourage registered investment advisers to incorporate changes to your compliance programs to ensure that client assets are properly safeguarded. I also wanted to acknowledge to advisers and their auditors that identifying misappropriation of assets can be a difficult task. However, as recent enforcement cases highlight, misappropriation of assets unfortunately does occur and therefore, advisers and auditors must be vigilant in their search for such activity.

Sophisticated Products: One area that exemplifies the need to address a rapidly changing market is in regard to investment companies' use of derivatives. I have, for some time, made no secret of my concerns regarding funds' use of derivatives and my belief that these instruments, while affording the opportunity for efficient portfolio management and risk mitigation, also can present potentially significant additional risk as well as raise issues of investor protection. In the past two decades, the investment company marketplace has been significantly reshaped by the use of derivative instruments. During this period, investment companies have moved from relatively modest participation in derivatives transactions limited to hedging or other risk management purposes to a broad range of strategies that rely upon derivatives as a substitute for conventional securities. Mutual funds that mimic hedge fund strategies, typically involving derivative products, have become commonplace. New categories of investment companies have emerged: absolute return funds, commodity return funds, alternative investment funds, long-short funds and leveraged and inverse index funds, among others. It is also not uncommon for investment companies with traditional investment objectives to obtain synthetic market exposure through derivative products, such as credit default swaps, rather than invest directly in stocks, bonds and similar securities.

Funds' use of derivatives presents concerns and risks on many levels – such as market, liquidity, leverage, counterparty, legal and structure risks. One of the challenges posed by derivatives is how to appropriately inform fund shareholders of these and other relevant risks as part of the SEC's disclosure and financial reporting regime. Losses to the fund and its shareholders can result from a complicated mix of events, making it more difficult to predict or model expected outcomes. Further, it can be difficult to describe these risks in language that is easily understood by shareholders.

The use of derivatives poses challenges for financial reporting as well. Recent changes implemented by the FASB have increased the transparency related to the use of derivatives within the financial statements. Those changes require, among other things, disclosure of how and why funds used derivatives during the financial reporting period within the notes to the financial statements. Unlike prospectus disclosure, which generally describes the types of derivatives into which a fund can enter, the financial statement disclosure relates to the derivatives into which the fund actually entered. I encourage funds to approach this disclosure thoughtfully with a mind towards informing shareholders as to how derivatives were actually used during the period to meet the objectives of the fund.

XBRL: In addition to these matters, the Division is also working to improve the quality of mutual fund disclosure. In this regard, I want to briefly mention some developments related to the use of XBRL, or eXtensible Business Reporting Language, for funds. On February 11th last year, the Commission adopted rules requiring funds to file their risk/return summary information in XBRL format and also to permit mutual funds to voluntarily submit portfolio holdings information in XBRL format without submitting the remainder of their financial statements in XBRL format. We recently issued a press release giving notice that the staff will conduct a public education seminar on June 4th regarding fund use of XBRL. The seminar will contain information that will help mutual funds and their financial statement preparers to comply with the requirements of the Commission's Risk/Return XBRL Rule and how to effectively utilize the new 2010 Risk/Return XBRL taxonomy. This is a great opportunity for preparers to better understand XBRL and how it will affect filings required under the Risk/Return Summary XBRL Rule and its implementation date of January 1, 2011.

Information – Current Issues

I now would like to turn to some issues that we are looking at in the Division that pose certain challenges, particularly with respect to the transparency of fund investments and their financial disclosures.

Private Investments: First, certain transparency issues arise with respect to fund investments in non-registered investment vehicles. For example, some funds have made significant investments in vehicles that are not offered to the public as a way to obtain exposure to alternative asset classes such as commodities, private equities, and, in some cases, investment vehicles that specialize in purchasing troubled-bank assets. Private investment vehicles, such as private equity funds, often do not provide shareholders with the level of transparency that would be typically expected for a mutual fund. However, if a fund chooses to invest a significant portion of its portfolio in private investment vehicles, the fund should determine if any additional material information may be necessary so that its prospectus and shareholder reports are not misleading.

Regulation S-X: In a related matter, I have asked the Division staff to compare the current accounting and reporting requirements contained within Commission rules to those generally required under US GAAP. As some of you may be aware, the last time the Commission made any significant changes to its financial reporting rules for investment companies was in 1982. Since that time, investment companies have evolved and are engaging in more complex investments and investment strategies that provide more risk to investors. If the staff perceives a need, we may recommend amendments, enhancements, or other clarifications of the Commission's financial reporting rules to address any differences with US GAAP.

IFRS and Investment Companies: Finally, I would like to discuss a particularly challenging issue that I am sure you are all familiar with, and one that is continuously ongoing – and that is the harmonization of accounting standards within the international financial community. Towards this end, the Commission recently issued a statement reaffirming its belief that moving to a single set of high-quality globally accepted accounting standards will benefit US Investors and supported the continued convergence effort currently under way between the FASB and the International Accounting Standards Board, the IASB. The Commission confirmed that this goal is consistent with its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation.

The Commission has long promoted the use of a single set of high-quality globally accepted accounting standards. In 2008, the Commission issued a proposed roadmap towards harmonization where it recognized that the International Financial Reporting Standards, IFRS, issued by the IASB is best positioned to serve as the accounting standard in the US capital markets. Commenters generally supported the goal of having a single set of high-quality globally accepted accounting standards, but differed in their views about the approach in the Commission's proposed roadmap. Some of benefits of incorporating IFRS into the financial reporting system that have been mentioned include 1) improved financial comparability among companies worldwide; 2) streamlined accounting processes for multinational companies; and 3) easier access to foreign capital and improved liquidity, leading to a reduced cost of capital.

However, while operating companies would likely take advantage of these benefits, investment companies would not. Critics of adopting IFRS for US investment companies have argued that IFRS does not provide accounting standards or guidance specific to the investment company industry and therefore would not reflect the nature of a fund's investment activity. Critics have also said that provisions of the Investment Company Act limit foreign investment companies from registering and selling their shares in the U.S., and that U.S. tax laws make U.S. funds less attractive to foreign investors because of the requirements under which funds distribute virtually all of their income and gains in order to avoid taxes at the fund level. In contrast, many foreign jurisdictions do not require their funds to distribute their income and gains and impose little, if any, capital gains taxes. Their shareholders would recognize taxes when they redeem their fund shares.

In spite of the fact that the perceived benefits of IFRS may not apply to investment companies, I challenge the industry to take a closer look at whether it really makes sense for US funds to take a different direction when it comes to incorporating the use of IFRS. First, the convergence efforts between the FASB and IASB have been underway since 2002 and there have been new FASB pronouncements affecting investment companies that are consistent with IFRS. So, in these respects, investment companies will be following IFRS. Second, there are instances in which many in the investment management industry would say that FASB's efforts with the IASB had a positive impact on the standard setting process. For example, FASB's amendments to consolidation would have resulted in many investment advisers having to consolidate the funds they manage, including money market funds. However, the FASB deferred these amendments, because IFRS could have potentially resulted in a different conclusion and because concerns were also expressed with the FASB's consolidation model for investment managers and the investment funds they manage. The FASB and the IASB agreed to address the issue in their joint consolidation project. So as you think about the use of IFRS for investment companies, I urge you to do so with an open mind.

In this regard, at the SEC, the Commission has directed the staff to develop and execute a work plan to assist it with its evaluation of IFRS for US issuers. The work plan is publicly available and it contains a dedicated section for investment companies. In the Division of Investment Management, we will be evaluating whether investment companies should be included in the scope of any potential Commission decision in this area. Our evaluation will include making a determination as to whether IFRS contains sufficient standards for investment companies, and to the extent that changes need to be made, what the timing of those changes would be. We also will evaluate the effect on investors if investment companies were excluded from the scope. As the staff continues with our analysis, I encourage you to share any feedback you may have on this issue. In particular, I would like to offer some specific questions for your consideration:

- Are the reporting differences between US GAAP and IFRS so materially different that transitioning to IFRS could lead to investor confusion?
- Would financial statements prepared in accordance with IFRS result in a financial reporting NAV that is different than the NAV used to process shareholder transactions?
- How does IFRS work with other provisions of the Investment Company Act that rely on the accounting results?
- Are there contractual provisions that would be implicated and what are the implications?

In relaying any feedback to the Commission, please note that the Division of Investment Management has its own Office of the Chief Accountant – currently led by Rick Sennett – that deals with accounting and auditing issues associated with investment companies.

This office can be a great resource for resolving existing accounting, financial reporting and auditing matters in this area. I encourage you to take advantage of the consultation process. I also think it is particularly important for investment companies to participate in the accounting standard setting process. I think there is a tendency for investment companies to overlook the fact that accounting standards apply as much to them as they do to any other company and that their participation in the process is very important. Commenting on proposed accounting standards issued by the FASB will ensure that accounting standards are set in a way that appropriately considers the impact on mutual funds. Your voices should be heard as the Commission and others consider issues such as accounting convergence, the role of IFRS in our reporting regime, and other future accounting and financial reporting matters.

SEC and CFTC: Announce the Creation of Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues

Background

On May 11, 2010, Securities and Exchange Commission Chairman Mary Schapiro and Commodity Futures Trading Commission Chairman Gary Gensler announced the formation of a joint committee that will address emerging regulatory issues. The establishment of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues was one of the 20 recommendations included in the agencies' harmonization report issued last year.

Information

The joint committee will develop recommendations on emerging and ongoing issues relating to both agencies. The first item on the committee's agenda is conducting a review of last Thursday's market events and making recommendations related to market structure issues that may have contributed to the volatility, as well as disparate trading conventions and rules across various markets.

To orient the Committee's work, the staff of the SEC and CFTC will provide to the Committee on Monday their joint preliminary findings regarding last Thursday's market events.

"As last week's events remind us, our markets are increasingly interrelated and interdependent so we need to appreciate how events in one arena can potentially impact investors and markets elsewhere," said Chairman Schapiro. "The Joint Committee will serve an essential role in addressing that challenge."

"It is important that we hear from this prominent panel of market practitioners, academics and former regulators about emerging risks in our markets," Chairman Gensler said. "It is critical that the CFTC and SEC hear from the panel together because our markets are so intertwined. I am particularly interested in the Committee's first focus: advising on courses of action in response to the lessons learned from the market events of May 6."

The Committee's charter provides for a broad scope of interest, including:
- Identifying of emerging regulatory risks.
- Assessing and quantifying of the impact of such risks and their implications for investors and market participants.
- Furthering the SEC's and CFTC's efforts on regulatory harmonization.

Chairman Schapiro and Chairman Gensler will serve as co-chairs of the Joint Committee.

Members of the Joint Committee include, with additional members to be added in the near future:
- Brooksley Born, Former Chair of the CFTC
- Jack Brennan, Former Chief Executive Officer and Chairman, Vanguard
- Robert Engle, Michael Armellino Professor of Finance at the NYU Stern School of Business
- Richard Ketchum, Chairman and Chief Executive Officer, FINRA
- Maureen O'Hara, Professor of Management, Professor of Finance, Cornell University
- Susan Phillips, Dean and Professor of Finance, The George Washington University School of Business
- David Ruder, Former Chair of the SEC

EBSA: News Release; Announces New E-signature Option for Forms 5500 and 5500-SF Electronic Filing

Background

The U.S. Department of Labor's Employee Benefits Security Administration announced on May 13, 2010, that the EFAST2 electronic filing system for Forms 5500 and 5500-SF employee benefit plan annual reports has a new e-signature option. This option is designed to simplify the electronic filing process, especially for small businesses that use service providers to complete and file their annual reports.

Information

Effective January 1, 2010, retirement and welfare plans required to file an annual Form 5500 or 5500-SF must file electronically using the department's new EFAST2 electronic filing system. More than one million Form 5500 reports are filed each year to satisfy annual reporting requirements under the Employee Retirement Income Security Act and the Internal Revenue Code. EFAST2 is designed to improve the receipt and processing of the Forms 5500 and 5500-SF.

Under the new e-signature option, service providers that manage the filing process for plans can get their own signing credentials and submit the electronic Form 5500 or 5500-SF for the plan. The service provider must confirm that it has specific written authorization from the plan administrator to submit the plan's electronic filing. In addition, the administrator must manually sign a paper copy of the completed filing, and the service provider must attach a PDF copy of the manually signed Form 5500 or 5500-SF as an attachment to the electronic filing submitted to EFAST2.

The service provider must communicate to the plan administrator any inquiries received from EFAST2, the Department of Labor, the Internal Revenue Service or the Pension Benefit Guaranty Corp. regarding the filing, and inform the plan administrator that, by electing to use this option, the image of the plan administrator's manual signature will be included with the rest of the annual return/report posted by the Labor Department on the Internet for public disclosure.

The additional e-signature option will be available in the government-sponsored IFILE application beginning May 13, 2010. Filers using EFAST2 approved software to complete and file the Form 5500 or Form 5500-SF should contact their software vendors for information regarding availability of this new e-signature option as part of their software.

Conclusion

The current EFAST2 frequently asked questions have been updated, and a new fact sheet and set of frequently asked questions have been developed to help small businesses understand this new option. Those materials are available through www.efast.dol.gov.

About the Author:

Mr. Moore is the Chief Executive Officer of Bearmoor, LLC an Asset Management and Fiduciary consulting firm. His concentration is Fiduciary Profit Enhancement, Risk Mitigation and Product Management. He has an extensive knowledge of the industry from both the regulatory and business perspective.

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Associated Bank
Trust Audit Senior
Green Bay, Wisconsin United States

Company Information
Headquartered in Green Bay, Wisconsin, Associated Banc-Corp is a diversified bank holding company with $23 billion in total assets. We have approximately 291 Associated Bank locations across Wisconsin, Illinois, and Minnesota focused on being the preferred provider of financial services for the businesses and individuals in the communities we serve. We value the diversity of our colleagues and recognize the strategic advantage that different backgrounds and perspectives bring to the achievement of our vision.

Job Description
Under limited supervision, supervise assigned personnel and lead audits of assigned departments / functions to ensure that the safekeeping of trust assets and records is in compliance with prescribed administrative and operational policies and procedures; evaluate the adequacy and propriety of policies and procedures. Supervise the activities of assigned personnel to maintain an efficiently –operating department; related activities include allocating work and reviewing workpapers prepared by other auditors. The review should include that workpapers are complete and accurate and that recommendations and comments are material and relative and are adequately documented. Carry out assignments discreetly, effectively and efficiently in sensitive and confidential circumstances. Ensure continuing development of professional relationships with client personnel. Perform trust audits as assigned by reviewing assets, records and operations in the audited areas to determine that all assets are accounted for, that the records are in order, that operations are efficient, and that adequate controls are being followed. Perform assigned field work in a competent and professional manner within time budgets. Demonstrate capacity and evidence for effective decision making and drawing sound conclusions. Identify system control points and document internal controls. Assist assigned personnel in the detection of weaknesses in controls and the resolution of discrepancies and in suggesting new and improved methods and controls. Direct and plan the activities of assigned personnel to ensure prescribed audit schedules are adhered to. Prepare audit reports and management letters based on findings and recommendations. Confer with audit supervisor / manager / Director and area management regarding the responses to the recommendations. Keep abreast of developments in accounting, trust operations and legal requirements impacting the audit function. Pursue continuing education opportunities to enhance personal knowledge and expertise. Provide assistance to external auditors in completing year-end audit procedures as required. Review the audit workpapers of assigned personnel, evaluating the completeness and accuracy of the work completed; ensuring all audit findings are properly identified and follow-up work is done as necessary. Demonstrate superior performance in all attributes of professional conduct. Encourage others toward comparable performance. Perform special examinations as assigned. Confer with external contacts as required by trust activities

Qualifications
Minimum Education: Four-year Accounting degree
Preferred Education: Four-year Accounting Degree with CPA, CIA, CFIRS/CTA certification
Minimum Experience: 3-5 Years pervious bank/trust auditing experience
Preferred Experience: 5-7 years previous bank/trust auditing experience

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- Conduct internal audit processes to validate the effectiveness of the control environment
- Assess existing internal audit processes for adequate scope and coverage, and provide guidance and support to bank audit staff
- Evaluate opportunities for operational improvements and provide value added recommendations
- Conduct Sarbanes-Oxley and FDICIA control evaluations
- Report findings to the client's management and Board of Directors as required

Qualifications:

- Bachelor's degree in relevant subject area required (accounting, auditing, finance, etc.)
- Minimum 5 years of banking and/or financial services experience, with at least 3 years experience in bank audit.
- High level expertise, knowledge and experience as Bank Internal Auditor or External Auditor with bank audit experience
- Professional designation such as CIA, CPA, CRCM, CFSA, CFE or prior experience as a bank examiner is a plus
- Strong documentation and report writing skills
- Working knowledge of regulatory environment and applicable banking regulations impacting the financial services industry.
- Ability to identify and communicate solutions to complex, time-critical or recurring business issues
- Excellent communication, organizational, and analytical skills.

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- Assess technology risks and implement monitoring processes and audit programs to mitigate identified risks
- Develop information security strategies and programs
- Evaluate information technology and privacy controls in a financial institution
- Assess existing internal audit programs for adequate scope and coverage
- Design, deploy and test business continuity and disaster recovery plans
- Design and implement vendor risk management program
- Perform IT audits including GLBA, FFIEC, Sarbanes Oxley, TG-3, merchant capture and PCI
- Report findings to the client's management, bank supervisors and Board of Directors as required

Qualifications:

- Bachelor's degree in relevant subject area required (systems, security, IT audit, etc.)
- Minimum 5 years of banking and/or financial services experience, with at least 3 years experience as an IT auditor or compliance manager in a financial institution.
- High level expertise, knowledge and experience with financial institution IT audit.
- Professional designation such as CISA or prior experience as a bank examiner is a plus
- Strong documentation and report writing skills
- Experience working with money center or regional bank holding companies a plus
- Working knowledge of regulatory environment and applicable banking regulations impacting the financial services industry.
- Ability to exercise discretion and independent judgment with respect to credit ratings.
- Ability to identify and communicate solutions to complex, time-critical or recurring business issues
- Excellent communication, organizational, and analytical skills.

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RISK CORNER

Winning in the New Risk Environment

Why large financial institutions need to consider adopting an enterprise-wide view of data across and within legal entities, business units, locations, and product lines

By Dolores Atallo-Hazelgreen, Director, Deloitte & Touche LLP

When John Hadley invented the sextant, could he have foreseen the development of the global positioning system?

Likely not.

When we look back at the near-collapse of the financial system in 2008, is it possible we will see the beginning of an era when banks have the tools and infrastructure in place to measure, monitor, and manage customer and transactional data and total exposures across legal entities, business units, locations, and product lines?

Is it likely that financial institutions will put in place a better enterprise-wide approach to data management and governance that can "peer through" the walls of operating silos to identify emerging patterns of risk that span their legal and operating structures, both domestically and internationally?

We hope so.

As we move toward that future, regulators, investors, and governing boards have begun to ask, how can banks move toward that likelihood?

- How can large banks better understand the combined exposures that they face?
- How can these organizations better understand the total risk concentrated in the customers and counterparties of their various legal entities?
- How can these entities better understand the totality of their exposure around the world by country, by business unit, and by product line?
- How can these organizations better respond to new and ad-hoc regulatory requests? In some cases it is difficult for these organizations to replicate existing reports that were created based on prior requests.

Too many silos

The answers lie, in large part, to the historically segregated approach that large financial institutions have followed to managing data.

The scale of some global organizations has been so great that they decided, over time, to manage their businesses by breaking things into smaller units. Some established a variety of legal entities either to meet local laws and regulations or for tax planning reasons when expanding their presence around the world. Many adopted a portfolio approach to running their businesses, giving senior management of the lines of business the autonomy to compete more nimbly in the marketplace.

Generally speaking, banks have been able to aggregate some of their data so that senior corporate management had the ability to understand how the lines of business were operating. But systems were not sufficient to aggregate data across the organization, which would have allowed them to measure and manage their risk on global, consolidated, and legal-entity levels. This would have helped banks to identify concentrations arising through common exposures or sensitivity to common shocks, and analyze the key linkages and exposures across their individual firms as well as in the system.

Regulators, investors, and governing boards are demanding more from systemically significant banks. This is especially true in banks that have newly configured boards of directors and/or new risk committees. There also is emerging discussion that would require large banks to create "living wills" or plans that would facilitate their orderly resolution should they fail.

A new risk environment

The model that segregates data by silo needs to change. Large banks must consider reversing their perspective and taking a top-down approach that values data as a strategic enterprise asset that must be actively managed, monitored, and maintained to support the broader goals of the organization.

Going forward, regulators, investors, and governing boards will likely expect banks to focus not only on the consolidated risk of the firm, but also on the risk that is taking place in multiple legal jurisdictions, business units, and product lines – while understanding the interrelationships of risk between and among all of these categories.

With expectations changing in the new risk management environment, banks will likely play by a different set of rules:

- ♦ An evolving demand by the global regulatory community and boards to improve IT system data capture may lead to improvements in risk identification, monitoring, and management.
- ♦ Quality data will be required for monitoring systemic risk and for implementing a new regulatory macro approach to supervision.
- ♦ There will likely be an increased focus not just on the consolidated risk of the firm, but also on risk in the legal, contractual and business relationships among the firm and its subsidiaries that cut across all the locations and jurisdictions.

- Large banks may need to consider how to complete their inventory of legal entities, correlate them to business lines, and how to provide a great deal of granularity on credit exposures, funding, on-pledge collateral, available lines of credit, cash flow, earnings, capital, and other metrics.
- They will also likely have to provide very detailed data to regulators on liquidity and the profile of assets and liabilities, down to lease agreements and documentation that is available in the organization.
- Finally, banks will need to consider developing a fully integrated risk-management framework that not only assesses market and liquidity risks within the firm, but also provides the ability for a firm to know its exposures such as the risk it faces through major counterparties.

This is a transformational approach to data risk management, one that will require a massive shift in risk culture, not to mention a serious realignment of priorities for IT investment.

Gaining competitive advantage

Banks that obtain a high level of granularity of risk measures through improved infrastructure may gain a competitive advantage as the industry continues to consolidate.

Large and even midsized banks with complex organizational structures may enjoy an advantage over their competitors by adopting an enterprise view of data management. Potential benefits of such an approach could include:

- Reduced infrastructure and human resources costs for the finance and risk management functions achieved through greater operational productivity and a more efficient and lower-cost technology;
- Higher return on equity resulting from improved capital management, active portfolio management, risk-adjusted profitability management, and risk-based pricing of business transactions.
- Enhanced ability to respond faster and with greater accuracy to increased regulatory information requests. As new reporting requests are made and information is provided by bank regulators in their supervisory assessments, greater confidence can be achieved that the information presented meets high standards for reliability, coherence, and data integrity.
- More opportunities for banks that qualify as "well-managed" to participate in regulator-facilitated business combinations. Regulators have more confidence in banks that can provide more timely, accurate, and comprehensive reports than in those that cannot provide such data.

Moreover, banks that take an enterprise-wide approach to data may be in a better position to cross-sell products to various segments of their customer base, both retail and commercial, because they will have a comprehensive view of information across all of their legal entities, business units, locations, and product lines.

Perhaps this compelling business opportunity, even more than the regulatory push resulting from the failures of the past few years, will provide large banks with the justification they need to begin the difficult, but necessary, process of tearing down the walls that separate their information assets and building an enterprise-wide system that is long overdue.

Implementing the data imperative: What might it take to win

With expectations changing in the new risk management environment, "winners" quickly understand the necessary investments, governance, architecture, and cultural changes needed to fulfill expectations.

Organizations may wish to perform an assessment to define the specific data and information needs of the organization. Subsequently, a plan should be developed to achieve the desired end state.

Issue	Action steps	Potential benefits
Embrace a culture shift	Embrace data as an enterprise strategic asset and reinforce this across the organization via data governance standards and practices.	Information management becomes a primary value driver and a core consideration within any decision making process.
Provide a seat at the executive table	♦ Appoint a Chief Data Officer to champion and govern data consistency and accountability across the enterprise. Businesses and functions should be required to use data in accordance with established data standards. ♦ Encourage and enforce data discipline throughout the financial institution by introducing data governance, establishing standards and policies, and defining	All functions and businesses will have a common reliable view of primary data information assets.
Define an enterprise data architecture	Define a single-target architecture for data management to extend across the global functions, decoupling data from the functional applications that utilize it.	♦ A single, shared end-state architecture improves access to high quality information across the enterprise and centralized, cross-functional shared services utility drives data quality reporting and monitoring. ♦ Duplicate data quality functions will be rationalized and standard data quality processes will be introduced where needed. In all cases, consistency will be enforced due to the centralized management of a single shared services utility.
Redirect existing resources	Eliminate redundant spending and redirect budget toward integrated, cross-functional, cross-sector projects that solve key issues, challenges, and opportunities.	Long-term reduction in total cost of technology and data management resources through the standardization of solutions and the resolution of common data challenges.

About the Author

Dolores Atallo-Hazelgreen specializes in advising Deloitte & Touche LLP's banking and securities services clients on risk management issues and corporate governance process transformation. She has more than 20 years experience assisting clients in customizing risk frameworks that focus on achieving business objectives and meeting industry standards.
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EXECUTIVE DIRECTOR

Leadership.

I do like to go to good ole' Webster's Dictionary. From Webster, leadership is "the function or position of a leader; ability to lead; or an act or instance of leading." The act and action are my purpose herein. It is always a bit dangerous to discuss such an often inflammatory word, because we are drawn to sensing the quality of leadership, but I am giving you my focus upon the role of leadership – the true virtue.

Leadership has always fascinated me with regard to its impact. Sometimes leadership is clearly recognized as it happens, like when William Wallace in *Braveheart,* on his steed and in blue-face, inspired his troops. Sometimes we listen to individuals and respond hoping the path is right and sensing the lead. Or sometimes, we simply realize after the fact that a person or organization should have been listened to or recognized as a leader. Bottom line, the sensing, hoping, and knowing are earned through a dramatic expression of energy, confidence, and right-thinking.

Leadership requires adaptability within boldness. Proven skills and styles learned over time are lost in leadership if they are not relative to the issues at hand. So, leadership must also recognize and embrace change – to be effective. And, honestly, the only true virtue of leadership is that it be effective.

FIRMA professionals are leaders, so I realize that I am preaching to the choir. But the reason for this message is to have you focus a minute upon recognizing leadership as well as leaders. An implicit role for FIRMA is to develop, showcase, and promote leadership principles to our members and to the industry.

Here is what leadership means to me:

….leading by example

…boldness to reasoned action and response

…follow-up

…constant learning – even learning from mistakes

…openness

Leadership is a commitment. FIRMA has a responsibility to provide leadership-attribute training within all of our education offerings. FIRMA confidently challenges all of our constituents to match our energy, clarity, and foresight. We embrace our role as a leader. We further embrace our role as a leader of leaders.

Sincerely yours,