Aon Advisor Solutions

Spring 2009 Newsletter

New Challenges Faced by the Financial Crisis

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The first six weeks of 2009 continued the downward market trends of 2008. The S&P 500, the DJIA and NASDAQ are all down over 20% for this year. In December 2008, it was reported that more hedge funds were being liquidated than established. Variable annuity sales fell by $10 billion in 2008. It seems like there is no place to profitably invest. At times like these, broker-dealers need to be extra diligent about their registered representative's outside business activities and broker-dealers and their insurers both need to be certain that broker-dealer policies adequately address potential "selling away" issues.

In climates like these, registered representatives – sometimes desperate for ways to earn a living – are susceptible to "get rich quick" schemes. In the earlier part of the decade we saw registered representatives get involved in schemes involving promissory notes, viaticals and even pay phones. The sales pitch from the program promoters was invariably the same – steady returns, low risk and because they were not securities the reps were told they did not have to report the sales to their broker-dealer.

In 2009, we should have learned from prior experience, but we have not. On February 17, 2009, the SEC charged Texas financier R. Allen Stanford with a "massive fraud" involving an $8 billion certificate of deposit program ("CD") marketed to 50,000 customers throughout the United States and the rest of world. According to the SEC, Stanford and his businesses misrepresented the safety of the deposits, falsely claiming the bank reinvested client funds in liquid financial instruments to help return profits on investments sharply higher than average rates of similar products. With $8 billion and 50,000 clients, there is no telling how many registered representatives were involved in this latest scheme. Registered representatives would have found it difficult to resist marketing a seemingly "safe" CD that paid 5.375% on a 3 year CD while comparable US Banks paid 3.2% on their CD's.

So, in this climate, we remind broker-dealers of their supervisory responsibilities for outside business activities. NASD Rule 3030 requires registered representatives to notify their broker-dealers in writing of any outside business activities (other than a passive investment). If the outside business activity involves a security, NASD Rule 3040 likewise requires the registered representative to notify his/her broker-dealer. If the transaction results in compensation to the registered representative, the broker-dealer must, in writing, either approve or disapprove of the registered representative's activity. If it approves of it, the transaction shall be recorded on the books and records of the broker-dealer and it shall supervise the registered representative's participation in the transaction as if the transaction were executed on behalf of the broker-dealer.

We note that the provisions of Rules 3030 and 3040 are simply minimum requirements of FINRA and do not insulate broker-dealers from liability for the selling away activities of registered representatives. FINRA and state regulators have often tried to impose liability on broker-dealers for their registered representative's selling away activities, even when the broker-dealer specifically prohibited the transactions. The reason is simple, regulators are looking for a deep pocket and by the time these programs typically fail, the registered representatives are in no position to provide restitution to the aggrieved public. So fair or not, broker-dealers are often on the hook for transactions that they may have known nothing about.

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So in times like these, broker-dealer compliance is critical. Broker-dealers must redouble their auditing efforts to make sure they get a complete picture of all of their reps' business activities, not just securities. If there is a sharp drop off in production, compliance professionals must be diligent in asking questions, as a sudden drop in production is a red flag that the rep has moved on to selling something else. The compliance professionals also need to use the audits as an opportunity to make sure there are no unfamiliar products in their client's portfolio.

From an insurance perspective, broker-dealers should carefully review their coverages with their insurance broker to make sure that selling away activity is included. From the insurers' point of view, underwriters must do their own due diligence to make sure that any potential selling away areas such as promissory notes, secured bridge loan financing, certificates of deposit are looked at and addressed in their policies.

The bottom line is that broker-dealers and their insurers should be ever vigilant about investment programs that appear too good to be true. They almost always are and they are usually uncovered when it is far too late to get their clients' investment back.

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