FIRMA™ 2011 ISSUE 2

FORUM

Estates and Trusts With International Contacts

PART 2

Fiduciary & Investment Risk Management Association™ Quarterly Magazine
WWW.THEFIRMA.ORG

FIRMA BOARD OF DIRECTORS

FIRMA UPCOMING EVENTS

FIRMA is pleased to offer the dates and locations for our upcoming programs.

Please visit the FIRMA website, www.thefirma.org, for agenda and registration information on these upcoming programs:

Training Seminars

Cleveland, OH
September 21 & 22, 2011

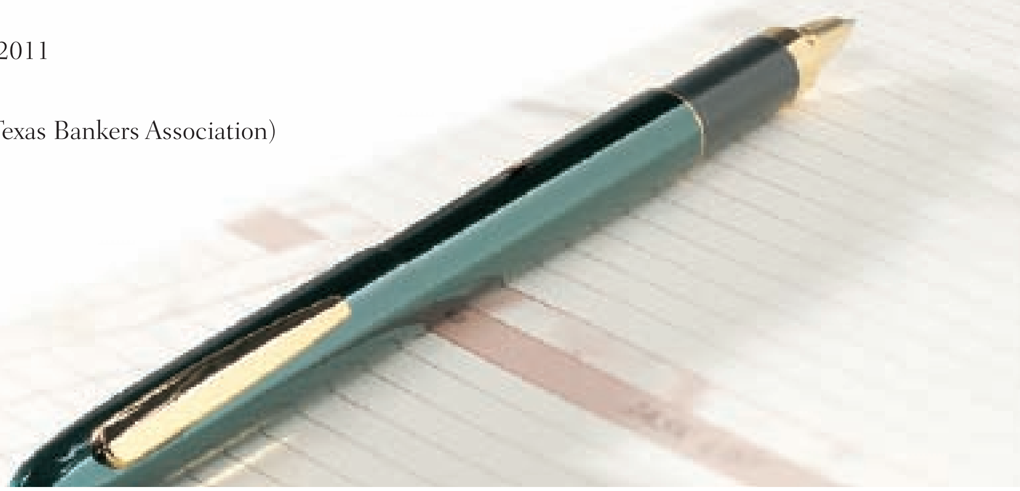
San Diego, CA
October 19 & 20, 2011

New York, NY
October 26 & 27, 2011

San Antonio, TX
(co-sponsored by Texas Bankers Association)
November 4, 2011

26th Annual FIRMA National Risk Management Training Conference

Fort Worth, TX
March 25-29, 2012



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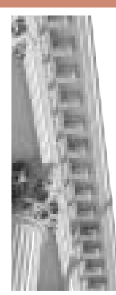
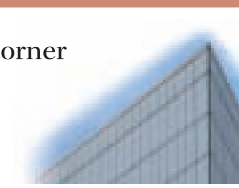




THE MISSION OF FIRMA

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 HIGHLIGHTS

The FIRMA 25th Annual National Risk Management Training Conference

Atlanta, Georgia

FIRMA celebrated its 25TH annual National Risk Management Training Conference April 17 - 21, 2011, at Atlanta's largest hotel, the Marriott Marquis. The conference offered two 3 hour Pre-Conference Workshops, a comprehensive three and a half day program consisting 13 General Sessions, two in-conference seminars, and 28 separate break-out sessions consisting of four separate study tracks. Other special events during the conference included FIRMA's Welcome Reception, hosted luncheons, annual membership meeting and for the first time a Vendor Showcase luncheon sponsored event.

The two Pre-Conference Workshops, "How To – Trust Audit" and "How To- Trust Compliance" offered attendees two benefits. First, they gained additional insights as well as the opportunity to sharpen and advance their skills. Secondly, attendees had the chance to arrive early and enjoy the many attractions such as the World of Coca Cola and CNN Studios, museums such as the High Museum of Art and Woodruff Arts Center, and fabulous restaurants full of character such as Pitty Pat's Porch and the Metro Café offered by the great city of Atlanta.

FIRMA Members enjoy 25th celebration

This year's conference offered many dynamic and renowned speakers. Paul Sobel, Vice President, Internal Audit, Georgia Pacific Corporation, delivered Monday's Opening Keynote Address, Dealing with New and Emerging Risks in an Ever Changing World. Tuesday's Keynote Session was delivered by Patrick Kuhse, Speaking of Ethics

Aware 4 Life, Inc. Mr. Kuhse presented, From Prominence to Prison: Why Smart People Do Dumb Things. He discussed his personal journey from successful stockbroker to prison as well as sharing lessons learned. Ty Boyd, Ty Boyd Executive Learning Systems, delivered Wednesday's Keynote Session Lessons in Leadership. Thursday's Keynote Session was led by Deborah Bailey, Director, Deloitte & Touche, LLP. Ms. Bailey discussed the significant implications the Dodd-Frank Wall Street Reform and Consumer Act will have in reshaping the financial landscape.

The conference officially began on Monday, April 18th with opening remarks from FIRMA Vice President Gary Pelcak who introduced and thanked the board members and the FIRMA team for all their efforts in planning this conference. Mr. Pelcak then introduced Tony Palma, Chairman of FIRMA's Development Committee, who introduced the 13 Sponsors at the 2011 25th Anniversary Conference. Mr. Palma then presented special Platinum Awards to three Sponsors who have participated as a sponsor for over five years – Insurance Trust Monitor, PDS Companies, and ProxyTrust.

New FIRMA President Bruce Goldberg and Director Carol Goulding

Mr. Pelcak then introduced the kick-off speaker, Paul Sobel. Following Mr. Sobel's Keynote presentation were two general sessions: Trust Legislative Update presented by Phoebe Papageorgiou, American Bankers Association (ABA), and SEC Custody Rule presented by Kenneth Berman and Gregory Lyons, Partners – Debevoise & Plimpton, LLP. FIRMA presented an award to Ms. Papageorgiou for recognition of the ABA's 25 year partnership with FIRMA.

In addition to a fabulous hosted luncheon on Monday, Dr. Denny Frederick, Frederick and Associates, discussed that we are going into a new, redefined, polished and appreciative economical change. Things look positive. The effect on each of us has been different and yet the same. We have re-evaluated our values, ethics, business standards, and appreciate many things we took for granted. "Retool" is a look at the future and how we each will personally handle it. How we use our tools will shape and is shaping global history.

Lunch was followed by two hours of concurrent breakout sessions: Critical ERISA Issues, Insurance Trust (ILIT) Risk Management, Data Breaches & Privacy, Bank Broker/Dealers – What You Should Know, Securities Lending and Counterparty Risk, SWIFT Administration of Alternative Investments, Corporate Trust Industry Overview for Risk. The day concluded with a General Session: 25-Year-Look-Back- FIRMA and the Fiduciary Industry. This General Session was hosted by Dominic Campisi, Duane Lee, and Hale Mast. All three of them shared memories and changes experienced by them in the industry and with FIRMA.

On Monday evening, all conference speakers, guests, and attendees were invited to attend the Welcome Reception from 6:00 – 8:00 PM in the hotel located on the 10th Floor Atrium level. This event was in response to requests from the FIRMA members for an event that would provide networking opportunities in a relaxed setting. The food was fantastic! In addition, members celebrated FIRMA's 25th Annual Conference anniversary with cake as well as special recognition was given to Cannon for their 25 year partnership with FIRMA. Friendships were renewed and many new ones made during this event. This reception was the

NATIONAL TRAINING

Speakers Satish Pattegar & Bev Antonich

Attendees Nanna Goodfellow & Fran DeMaris

Attendees Harvey & Eileen Avidon and Satish Pattegar

Attendee Patrick Stanley

FIRMA's Board of Directors

Executive Director Hale Mast cuts the birthday cake.

perfect way to close the very busy and exhausting first day.

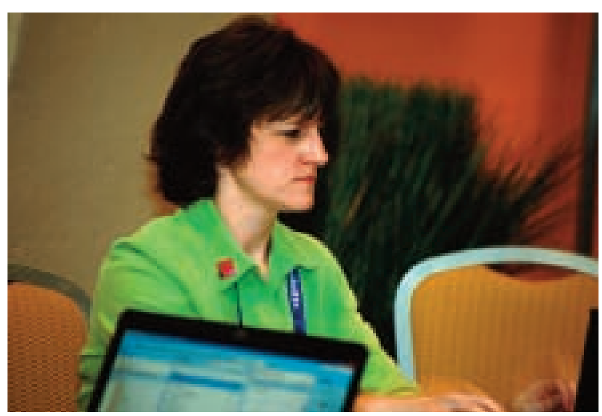
Following the Keynote Session on Tuesday of the FIRMA conference featured a three general sessions and two In-Conference Seminars. Tuesday's three general sessions consisted of a Regulator Panel, the return of Ellen Beeson Zentner, Senior Economist, Bank of Tokyo Mitsubishi UJF, Ltd. , who presented The U.S. Economic Update – Are We There Yet?, and Clint Lackey, Wells Fargo, who presented Conflicts of Interest – What are They Now?.

This year a Vendor Showcase was introduced into the conference. The vendors that participated were: Broadridge, Insurance Trust Monitor, Nth Degree Financial Solutions, PDS Services, ProxyTrust, and Trust Imaging Systems. Lunch was provided to those that attended and each vendor was able to provide a brief overview of their services.

This is the sixth year for offering 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 seminars were titled: "FDIC Purchase and Assumption Agreement Overview," presented by Jim Strickland, Citigroup and "Elements of Investment and Administrative Reviews," presented by Beverly Antonich, US Bank, and Kathryn Vest, SunTrust Banks, Inc.

Wednesday offered four separate tracks consisting of Hot Topics, Investments, Operational Risk, and Regulatory. Twenty breakout sessions were available which enabled all conference attendees to tailor the training sessions to their own needs. The breakout sessions included topics: Tricks and Traps of Subpoena Compliance, How To Be an Employer of choice, Profiling the White-Collar Criminal, Vendor Risk Management – In the Age of Outsourcing, new Product & Strategic Initiative Oversight, Managing Risk through Performance Measurement, Due Diligence for Hedge Funds & Private Equity, Mutual Funds & Money Managers, Cost Basis Reporting, Proxy Voting – Operational Focus, Challenges in Managing Corporate Actions, Valuations – How to, Derivative 101, Global Operations, AML – What is Means for Wealth Risk Management, Reg R Workshop, and Estate Tax.

Also on Wednesday, the FIRMA Annual Membership meeting was scheduled in conjunction with lunch, 11:45 am -1:15PM pm. All FIRMA members and nonmembers 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.



Amy Caple works the registration desk.

During the opening session on Thursday morning, Larry Musher, FIRMA Nominations Committee Chair, announced Deborah Austin returning for her 3rd term as a member of the FIRMA Board of Directors. Bruce Goldberg was re-elected for another three year term. Tony Palma and Jennifer DeVries were elected to their first

NATIONAL TRAINING

three year terms after filling unexpired terms. Larry noted that Bruce Goldberg was elected as President, Jennifer DeVries elected as Vice President and Bradley Beshea was elected as Secretary to the FIRMA Board.

Following the Keynote speaker, Deborah Bailey Thursday, were three General Sessions: Social Networking – What You Can and Cannot Do, presented by Christine Farquhar and J. Aaron Sullivan, The Benefits and Risks of Technology presented by Sandra Sherman, and the Class Actions presented by Dr. Francis McGovern.

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 26th National Risk Management Training Conference March 25-29, in Fort Worth, Texas, at the spectacular Worthington Renaissance Hotel.

Contributing Writers: Jennifer DeVries, Amy Caple, Tony Palma, and Hale Mast.
Photos by Harvey Avidon.

Our AV Team

The Cannon Team receives a 25-year partner award

Our FIRMA Vendors

COVER STORY

Fiduciary Administration and Compliance: Estates and Trusts with International Contacts – Part Two

By Suzanne L. Shier and Rebecca Wallenfelsz

I. Introduction

The administration of estates and trusts increasingly involves international contacts. A settlor or a beneficiary may be a foreign person. The estate or trust itself may be treated as a foreign estate or trust for tax purposes. Following is Part Two of a two part article which discusses the various tax implications of estates and trusts with international contacts. Part One discussed (1) the determination of the status of a person, estate and trust as domestic or foreign for U.S. income tax purposes, (2) the income tax and compliance issues asso-

ciated with foreign trusts with U.S. settlors or beneficiaries, (3) the income tax and compliance issues associated with transfers from U.S. estates and trusts to foreign beneficiaries, and (4) the income tax and compliance issues associated with transfers from U.S. individuals, estates and trusts to foreign estates and trusts. This part discusses (1) the gift, estate and generation-skipping transfer ("GST") taxation of transfers among U.S. and foreign persons, estates and trusts, and (2) expatriation.

II. Transfer Tax Issues/Reporting

This section briefly discusses the U.S. estate, gift and GST tax (collectively, "transfer tax") and reporting requirements for non-resident aliens, the issues and reporting obligations on U.S. recipients of those transfers, and the issues for transfers by a U.S. individual to a foreign beneficiary, estate or trust.

A. Definitions

1. Non-Resident/Citizen vs. U.S. Resident/Citizen

As with U.S. income taxes, U.S. transfer taxes (gift, estate and GST) are imposed on U.S. citizens and residents on their worldwide assets. Non-residents are only subject to transfer taxes upon the transfer of U.S. situs assets (discussed below). However, the definition of residency for transfer tax purposes is different than the definition for income tax purposes discussed above. Non-citizens who are U.S. residents for income tax purposes are not necessarily residents for purposes of gift, estate and GST taxes. For transfer tax purposes, an individual's residence or residency refers to domicile. The regulations provide a general description of what it means to have "domicile" rather than a precise definition. Domicile is the place where an individual lives with no intent to remove therefrom.[1] Domicile will depend on the intent of individual.

2. Foreign Situs Assets vs. U.S. Situs Assets

The definition of U.S. situs property for gift tax purposes is slightly different than the definition for estate tax purposes. For both gift and estate tax purposes, real property and tangible personal property physically located in the U.S. has a U.S. situs.[2] For gift tax purposes, intangible personal property does not have a U.S. situs, whatever its source or location.[3] For estate tax purposes, however, intangible personal property has a U.S. situs if it is derived from a U.S person or entity. As such, stock issued by a U.S. domestic corporation[4] and debt obligations issued by or enforceable against any U.S. person or entity[5] has a U.S. situs for estate tax purposes. However, the Code specifically excludes the following types of property as U.S. situs property for estate tax purposes (1) proceeds from and interest on a life insurance policy issued by a U.S. company,[6] (2) U.S. bank and savings and loan association deposits,[7] (3) portfolio debt obligations issued after July 18, 1984,[8] and (4) works of art on loan for exhibition.

B. Transfer Tax Treaties

While there are many countries that have income tax treaties with the U.S., there are many fewer that have gift, estate and GST tax treaties with the U.S. These treaties should be consulted to see if they address (1) the definition of residency and/or domicile, (2) dual residency/citizenship, (3) the taxable situs of assets, and (4) transfer tax exemption/credits.

C. Transfers by Non-Resident Aliens

Non-resident aliens are only subject to U.S. gift, estate, and GST tax to the extent the transfer involves U.S. situs assets. Like U.S. residents and citizens, a foreign person may make gifts up to $13,000 of U.S. situs assets each year to a donee without incurring U.S. gift tax.[10] However, a married foreign donor may not take advantage of the gift-split election. In addition, the $5,000,000 lifetime gift tax exclusion applicable to U.S. resident and citizen does not apply to foreign donors.[11] A foreign person does receive an estate tax exclusion of $60,000 for U.S. situs assets owned at death, unless an applicable estate tax treaty between the U.S. and the decedent's country provides for a higher exemption.[12] Foreign donors and decedents currently are allowed the same $5,000,000 GST tax exemption that is available to U.S. citizens and residents.[13]

D. Reporting/Payment Obligations of U.S. Recipients

If a U.S. person receives a gift or bequest from a nonresident alien or a foreign estate, the U.S. person is required to report the gift or bequest on Form 3520 if the gift or bequest was either (a) more than $100,000, or (b) more than the annual exclusion amount (currently $13,000) and from a "covered expatriate". A covered expatriate is a U.S. citizen or certain long-term resident aliens who renounce their citizenship or terminate their residency with the principal purpose of avoiding tax (which is presumed in certain circumstances).[14]

If the gift or bequest is subject to U.S. gift, estate or GST tax, but is not reported and/or a return is not filed by the donor or the estate, the U.S. beneficiary will be required to file the appropriate return and pay the transfer tax.[15]

If the gift or bequest is from a U.S. expatriate, special transfer tax rules are applicable to the U.S. beneficiary.

E. Transfer Tax Issues — Reporting for U.S. Individual to Foreign Beneficiary

A bequest or gift by a U.S. person to a foreign individual, estate or trust does not trigger any unique or special U.S. transfer tax rules. The same gift, estate and/or GST tax rules apply to the U.S. individual regardless of the nationality of the donee/recipient. However, a U.S. individual who transfers property to a foreign estate or trust may have income tax consequences and additional reporting obligations. These rules were discussed above in connection with the income tax rules for these types of transfers.

III. Expatriation

A. Who is an Expatriate?

U.S. citizens and certain long-term resident aliens who renounce their citizenship or terminate their residency (*"expatriates"*) with the principal purpose of avoiding tax are subject to special expatriation tax rules for a period of 10 years following the loss of their citizenship or termination of residency (*"expatriation"*).[16] Long-term U.S. residents subject to this tax are alien individuals who were lawful permanent residents (*i.e.,* green card holders) for at least 8 taxable years during the 15-year period ending with the taxable year in which such individual ceases to be taxed as a resident of the United States.

Former U.S. citizens and long-term residents who have expatriated are automatically deemed to have a principal purpose of tax avoidance if they meet certain thresholds with respect to their net worth or their average annual tax liability. The individual is treated as having a principal purpose to avoid tax if (1) his average annual net income tax for the 5 taxable years prior to expatriation is greater than $124,000, adjusted for inflation (the *"tax liability test"*), or (2) his net worth as of the date of expatriation is $2,000,000 or more (the *"net worth test"*).[17]

In addition to the income and transfer tax consequences discussed below, expatriates also risk being reclassified as U.S. residents, for income and transfer tax purposes, if during the 10-year period following expatriation, the individual is physically present in the U.S. for more than 30 days.[18]

B. Income Tax Implications

For individuals who expatriated on or before June 16, 2008, the expatriate is subject to tax under Code § 877 on all their U.S. source income, just like all other non-resident aliens; however, the definition of U.S. source income is broader and the U.S. source income is taxed at the graduated rates applicable to U.S. citizens and residents rather than the flat 30% or lesser treaty rate for non-resident aliens. If the tax liability calculated under Code § 877 exceeds the liability under Code § 871 (which is the general tax provision for non-resident aliens), the taxpayer must pay the tax as calculated under Code § 877 (i.e., the taxpayer must pay the greater of the two taxes).

For individuals who expatriate on or after June 17, 2008, the Code provides a mark-to-market exit tax (i.e., a gain recognition tax) on the expatriates.[19] The net gain on the deemed sale is recognized to the extent it exceeds $600,000, adjust for inflation.[20]

If an expatriate is the beneficiary of a non-grantor trust on the day before the expatriation date, following the expatriation date, if the trustee distributes (directly or indirectly) property to the expatriate, the trustee must (1) deduct and withhold an amount equal to 30% of the taxable portion of the distribution, and (2) if the distribution is in kind, recognize gain if the fair market value of the property exceeds its adjusted basis. The expatriate is deemed to have waived any right to claim any withholding reductions under any U.S. tax treaty unless the covered expatriate agrees to some other treatment that the IRS determines is reasonable.

C. Transfer Tax Implications

For gifts by individuals who expatriated on or before June 16, 2008, the same gift tax rules that apply to non-resident aliens apply to expatriates. However, intangibles from U.S. sources (*i.e.,* U.S. corporate stocks/bonds/notes) are treated as U.S. situs assets so long as the expatriate is subject to the alternative tax imposed under Code § 877.[21]

For estates of individuals whose expatriation date was on or before June 16, 2008, a tax computed under the Code § 2001 table is imposed on the transfer of the taxable estate of the decedent if the date of death occurred during a tax year in which the decedent was subject to the alternative tax imposed on expatriates under Code § 877.

For individuals who expatriate on or after June 17, 2008, a new Code § 2801 imposes taxes on certain gifts and bequests received from a "covered expatriate." This tax is imposed on the U.S. donee or beneficiary of the gift or bequest.

The tax applies to any "covered gift or bequest" valued in excess of the annual exclusion amount in effect for gift tax purposes in the year of the transfer. A "covered gift or bequest" is any property acquired by gift, directly or indirectly, from an individual who, at the time of the gift, is a covered expatriate and any property acquired, directly or indirectly, by reason of the death of an individual who, immediately before his death, was a covered expatriate. The tax under Code § 2801 is paid by the person who receives the covered gift or bequest. Although a covered gift is similar to a net gift, because the recipient of the covered gift is liable for the tax on the gift, neither the Heroes Act (Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245) which introduced this code section, nor the committee reports state that the value of a covered gift is computed in the same way as the value of a net gift.

IV. Conclusion

In summary, administration of estates and trust with international contacts adds an additional layer of complexity to the administration, tax reporting and compliance responsibilities of the fiduciary, the fiduciary's advisors and fiduciary compliance professionals. The globalization of the economy and the related globalization of estate and trust administration requires familiarity with the associated compliance requirements.

Footnotes

1 Treas. Reg. §20.0-1(b)(1).

2 Treas. Reg. §§ 20.2104-1(a)(1), (2), 25.2511-3(b)(1), (2). Currency is treated as tangible personal property. Treas. Reg. §§ 20.2104-1(a)(7), 25.2511-3(b)(4)(iv).

3 Internal Revenue Code of 1986 ("Code") § 2501(a)(2). In PLR 9119049, the IRS ruled that a mutual fund, which consisted of municipal bonds and securities, was intangible personal property and the non-resident alien was not subject to U.S. gift tax.

4 Treas. Reg. §§ 20.2104-1(a)(5), 25.2511-3(b)(3). In TAM 9748004, the IRS ruled that shares in an open-ended U.S. investment company (i.e., a mutual fund) are treated as stock of a U.S. domestic corporation for purposes of the situs rules.

5 Treas. Reg. §§ 20.2104-1(a)(7), 25.2511-3(b)(4).

6 Code § 2105(a).

7 Code §§ 2105(b)(1), 871(i)(3). U.S. bank deposits include money in a checking, savings or unrestricted agency account and certificates of deposit. See Estate of Gade, 10 T.C. 585 (1948); Estate of Forni, 47 B.T.A. 76 (1942); Rev. Rul 82-193, 1982-2 C.B. 219. Cash in a bank's safe deposit box is not a U.S. bank deposit. Rev. Rul. 55-143 1955-1 C.B. 465. In addition, funds held by a bank in a fiduciary capacity where the beneficiary's access is restricted do not constitute U.S. bank deposits. Rev. Rul. 69-596, 1969-2 C.B. 179. A brokerage firm is not in the banking business, and cash held by a U.S. brokerage firm will still have a U.S. situs. Rev. Rul. 65-245, 1965-2 C.B. 379.

8 Code §§ 2105(b)(3), 871(h). The types of obligations that can qualify as portfolio debt obligations include U.S. government obligations, obligations issued by agencies of the U.S., obligations issued by states, counties, cities and public authorities, obligations of U.S. corporations and partnerships. However, it is unlikely that debt obligations issued by a U.S. individual would qualify. See Code § 871(h)(2), (3). In TAM 9748004, the IRS held that a unit investment trust which held portfolio debt obligations was treated as non-U.S. situs property under Code § 2105(b)(3).

9 Code § 2105(c).

10 Code § 2503(b).

11 Code § 2505.

12 Code § 2102(b)(2).

13 Code § 2631.

14 Code § 877.

15 Code § 6901(a)(1)(A)(ii), (iii).

16 Code § 877

17 Code § 877(a)(2)(A), (B). For calendar year 2010, the threshold amount is $145,000 for the tax liability test. Rev. Proc. 2009-50, 2009-45 IRB 617.

18 Code § 877(g)(1).

19 Code § 877A.

20 The amount is $627,000 in 2010. Rev. Proc. 2009-50, 2009-45 IRB Sec. 3.27.

21 Code § 2107.

About the Authors:

Suzanne L. Shier is a managing partner with the law firm of Chapman and Cutler in Chicago, where her practice focuses on all aspects of fiduciary services and risk management and individual private client services. Ms. Shier was named a Leading Estate Planning Attorney by Leading Lawyers Network and has been included in the Illinois Super Lawyers list for the past several years. She is a member of the select estate planning organization, the American College of Trust and Estate Counsel, and an adjunct professor in the Master of Laws in Taxation Program at Northwestern University Law School.

Rebecca Wallenfelsz is a partner with the law firm of Chapman and Cutler in Chicago, where her practice focuses on fiduciary advisory services, including fiduciary litigation, and individual private client services. Ms. Wallenfelsz is an active participant in the American Bar Association, Section on Real Property, Probate and Trust Law and in the Chicago Bar Association, where she serves as Chair of the Trust Law Committee. Ms. Wallenfelsz is also a frequent speaker and author.

DISCUSSION TOPIC

Synergies Between Fiduciary and Investment Specialists in Fiduciary Risk Evaluation

By: David Crandall and Todd Sauer, RSM McGladrey

As financial products become more complex, there is a need to bring investment risk specialists into the process to better understand products, strategies and associated risks. An effective way of identifying and assessing these risks is for the specialists to work hand in hand with fiduciary risk professionals through the risk review process.

1. The investment risk specialists can help fiduciary risk specialists and examiners understand new and complex products being offered by the Company and their associated risks.
2. The specialists can assist in identifying, assessing and testing internal controls.

3. Many of the risks the specialists will review are higher risk and complex areas, and thus will likely require additional analysis.
4. Specialists can provide recommendations for action to reduce risk that can then be included in the ongoing monitoring of controls after implementation.

A closer look at specialized fixed income investment risks

Particular areas to focus on might include the use of hedging programs and structured products and the impact of market fluctuations on overall portfolio risk. Additionally, the investment specialist can help to review the quality of models used to monitor performance of these products.

Examining a company's hedge program requires the need for a thorough review of the hedging strategy as well as the associated reporting capabilities to monitor performance of the hedge. Many of the products used within a dynamic hedging program rely heavily on the ability to forecast and predict the behavior of the investment(s) being hedged. In this case, understanding the potential variability in the expected outcomes is critical to a successful hedge program. The relationship between the investment being hedged and the hedging vehicle can be better analyzed by individuals with both investment and fiduciary experience. A good dialogue is a must.

In the case of structured products, the fiduciary risk and investment professionals should consult with fiduciary investment managers to fully understand the profitability assumptions and payoff features of any new products. For example: Some products are more profitable than others, which could cause a significant change in the account's profitability. The risk tolerance of the fiduciary client is an important factor in determining whether the strategy is acceptable. Risk professionals can work with investment managers to understand the reasons why there might be a change in profitability due to the performance of the structured product. Over the years, many new investment products such as Collateralized Debt Obligations and Securities (CDO's and CDS's) have been included in the portfolios of large investors and pension funds. The use of an investment specialist can assist the fiduciary risk professional or examiner in identifying risks associated with these products and also, more importantly, help focus on areas where these risks might negatively affect the trust portfolio.

The impact of market fluctuations plays a critical role in the profitability and investing ability of a financial services company. The movement of market rates or prices such as interest rates, forex rates and equity prices can adversely affect the reported value of investments. One might typically think that this area only affects the investment management group within a company. The reality is there are two areas that must be considered given the types of risk involved:

1) How does the change in rates impact the investment valuation?
2) When might certain guarantees in the instrument be activated based on this type of market movement?

Understanding the dynamics of certain market movements is critical when it comes to analyzing the risks and associated mitigation strategies employed by various companies.

The evolution of investment products throughout the years has created a complex system of models and systems used to run these models. Fiduciary investment managers have specific models in place to predict financial markets, consumer behavior and overall economic forecasts. Synergies between investment and fiduciary risk professionals can play an important role in evaluating the use of these types of models. For example: What type of models predict certain optionality in structured products such as EIA's and are they working closely with investment professionals in determining market assumptions?

Another case might be the use of Monte Carlo methods. The impact of potential model errors can cause significant financial damage and create uncertainty in the portfolio performance. Multiple risks identified within the process can be tied back to the use of models and the overall model design. Understanding what may cause a "break in the model" is critical when examining certain model-related controls.

DISCUSSION TOPIC

Real Life Scenario*

The portfolio manager purchases a hedge product which balances best possible replication with cost and other factors. Replication attempt hinges on interpreted output from the investment model(s) and so within the fiduciary investment review function, the need for frequent and effective communication between portfolio managers and the fiduciary risk specialists is crucial. Hedged assets are defined by several parameters that include notional value (corresponding to amount at risk), weighted fund return, duration and volatility. Questions asked of the company in this type of situation could include:

- Do the hedged asset values truly exceed the true value for the guaranteed benefit in a large percentage of scenarios?
- Does the derivative cover the full amount at risk?
- Does the weighting of indices chosen replicate the weighted funds underlying the contract account values?

Our team spent time with the company's team understanding the method and then tested controls over valuation models, tested sample cash flows, vetted model assumptions, and reviewed/questioned hedging reports.

The investment portfolio valuation of this type of contract relied on complicated investment valuation methodology performed within the company's investment department. The company understood this reliance and was comfortable with it. We needed to conclude that the hedged asset valuation is equal to the benefit credit valuation or is more conservative in the aggregate (conservative in this case). In our case, this conclusion required the examiners, fiduciary risk management and investment staff to deliberate and conclude on the issue.

**Of course, the actual company case differed in certain circumstances, but the spirit of the scenario was preserved in our example.*

Conclusion

We have learned a lot from working together with people possessing a variety of skills and involving companies with issues that overlap more than one person's skill set. Of absolute necessity is the need for frequent communication between team members, even if it is not initially clear that they will be tackling the same issue together. When scoping the exam during the planning phases, one should try to leave room within the work plan to anticipate the synergistic risk possibilities that are likely to occur, especially when examining more complex companies. We have found that synergistic risks are not always apparent in the planning stage. Finally, one should try to leave time in the budget for deliberation over dealing with these risks and the likely need for follow-up questions or meetings with the company. Understanding, explaining and documenting the conclusions from these extra discussions could extend the original timeline established in the planning phase.

About the authors:

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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 2011 quizzes with Issue #1 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 *2011 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.

1. On May 6, 2011, SEC Chairman Mary L. Shapiro spoke at the general membership meeting of the Investment Company Institute. Chairman Shapiro spoke about the events that happened on May 6, 2010, as stock prices began to fall with almost unprecedented speed. In April, the exchanges and FINRA, working with Commission staff, proposed a major expansion and enhancement of the pilot circuit breaker program aimed at addressing extraordinary volatility. This proposal, dubbed the Volatility Plan offers many potentially important changes. The proposed plan would:

   I. Expand the pilot circuit breaker program in two significant respects. It would extend circuit breaker protection to all U.S.-listed equities. And, it would apply circuit breakers during the opening and closing periods of the day, which currently are not covered by the pilot program.
   II. Add a "limit up-limit down" mechanism. This would address weaknesses in the pilot program that permit a single erroneous trade to trigger a full trading pause.
   III. Cut in half the price parameters that would trigger a pause, from 10 percent to 5 percent. This would greatly reduce the scope for sudden price moves.
   IV. Allow organizations of a certain size to opt out of the plan.

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

2. The SEC approved FINRA's proposal to adopt rules governing books and records for the consolidated FINRA rulebook. The new rules, which are modeled after NASD Rule 3110, NYSE Rule 440 and NYSE Rule Interpretations 410/01 and 410/02, require member firms to make and preserve certain books and records to show compliance with applicable securities laws, rules and regulations – and to enable FINRA and SEC staffs to conduct effective examinations. The new rule requires firms to do which of the following:

   I. Maintain the name of the associated person, if any, responsible for the account.
   II. When multiple individuals are designated as being responsible for an account, the firm is required to maintain each of their names and a record indicating the scope of their responsibilities with respect to the account.
   III. Maintain the signature of a partner, officer or manager of the firm with respect to an account to denote that the account has been accepted in accordance with the firm's policies and procedures for acceptance of accounts.
   IV. All signatures must be handwritten and notarized, electronic signatures will not be accepted.

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

FORUM QUIZ

3. The SEC approved FINRA's proposal to adopt a rule governing fidelity bonds for the consolidated FINRA rulebook. Each firm subject to the rule must maintain, at a minimum, fidelity bond coverage for any person associated with the firm, except directors or trustees who are not performing acts within the scope of the usual duties of an officer or employee. For firms with a minimum net capital requirement that is less than $250,000 the minimum coverage that is to be maintained is the greater of ____% of its required minimum net capital under Exchange Act Rule 15c3-1 or $______.

   A. 125% and $100,000
   B. 150% and $250,000
   C. 120% and $100,000
   D. 125% and $125,000

4. The Securities and Exchange Commission intends to issue an order that would adjust two dollar amount tests in the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge performance based compensation to "qualified clients." The proposed amendments to rule 205–3 include the exclusion of the value of a person's primary residence from the determination of whether a person meets the net worth standard required to qualify as a "qualified client."

   A. True
   B. False

5. The Department of Labor is reviewing the use of electronic media by employee benefit plans to furnish information to participants and beneficiaries covered by employee benefit plans subject to the Employee Retirement Income Security Act (ERISA). The Department recognizes that there have been substantial changes in technology over time, both in the workplace and at home. In light of these changes and the significance of the issues surrounding the use of electronic disclosure, the Department has decided to explore whether and how to expand or modify the current standards under ERISA applicable to the electronic distribution of required plan disclosures. Currently the electronic disclosure rules under ERISA provide for a safe harbor and include which of the following:

   I. The plan administrator takes appropriate and necessary measures reasonably calculated to ensure that the system for furnishing documents results in actual receipt of transmitted information and protects the confidentiality of personal information relating to the individual's accounts and benefits.
   II. The electronically delivered documents are prepared and furnished in a manner that is consistent with the style, format and content requirements applicable to the particular document.
   III. Notice is provided to each participant, beneficiary or other individual, in electronic or nonelectronic form, at the time a document is furnished electronically, that apprises the individual of the significance of the document when it is not otherwise reasonably evident as transmitted and of the right to request and obtain a paper version of such document.
   IV. Upon request, the participant, beneficiary or other individual is furnished a paper version of the electronically furnished documents.

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

6. Effective July 21, 2011, the statutory prohibition against the payment of interest on demand deposits will be repealed pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the DFA). In light of this, the FDIC proposes to increase regulations to continue to implement this prohibition with respect to state chartered nonmember (SNM) banks.

   A. True
   B. False

7. A gift or bequest by a U.S. person to a foreign individual, estate or trust does not trigger any unique U.S. transfer tax rules.

    A. True
    B. False

8. If a U.S. person receives a gift or bequest from a nonresident alien, the U.S. person is not required to report the gift on Form 3520 if the gift was less than $100,000 or less than the annual exclusion amount and not received from a "covered expatriate."

    A. True
    B. False

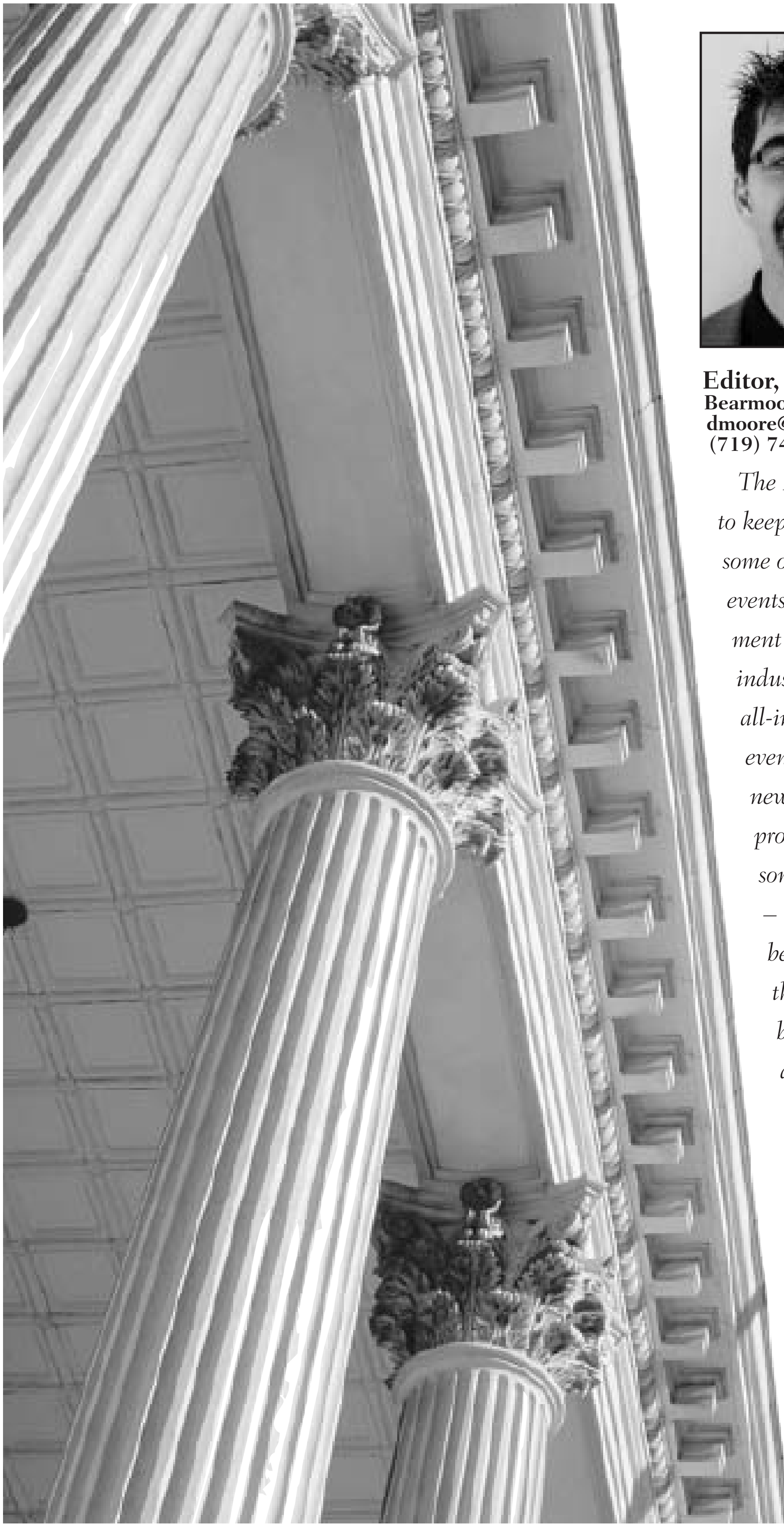
9. U.S. transfer taxes are imposed on U.S. citizens and residents on their foreign assets only.

    A. True
    B. False

10. Income tax treaties that the U.S. has with other countries should be consulted to see if they address several items, one of which is dual residency/citizenship.

    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: *As we move into the spring of the year and our thoughts turn to summer vacation plans we must remain diligent in our compliance efforts, for there continues to be many new pronouncements coming from the agencies. We begin this issue with an SEC Proposed Rule on investment advisor performance compensation and the adjustment of two current rules. Next we have two FINRA Regulatory Notices dealing with books and records and fidelity bonds. EBSA has put out a Request For Information regarding the use of electronic disclosures by EB plans – changes in technology and its use have prompted EBSA to request this information so you need to be aware of what they are looking for. Also included in this issue is an excerpt from a speech given by SEC Chairman Shapiro on the agency's effort to address the events that took place in May of 2010. The FDIC has a Proposed Rule regarding the ability to now pay interest on deposits as outlined in the Dodd-Frank Act. This will have an impact on how banks and their trust departments view deposits. And finally, although the tax season is behind us I included an item specific to the IRS enforcing their tax preparer rules. Should you have specific items you would like to be presented/discussed in the Regulatory Update, please send your requests to the attention of the* FIRMA FORUM *Editor, or myself.*

SEC: Proposed Rule – Investment Advisor Performance Compensation

Background

The Securities and Exchange Commission ("Commission" or "SEC") intends to issue an order that would adjust two dollar amount tests in the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge performance based compensation to "qualified clients." The adjustments would revise the dollar amount tests to account for the effects of inflation. The Commission is also proposing to amend the rule to: provide that the Commission will issue an order every five years adjusting for inflation the dollar amount tests; exclude the value of a person's primary residence from the test of whether a person has sufficient net worth to be considered a "qualified client;" and add certain transition provisions to the rule.

Section 205(a)(1) of the Investment Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client. Congress prohibited these compensation arrangements (also known as performance compensation or performance fees) in 1940 to protect advisory clients from arrangements it believed might encourage advisers to take undue risks with client funds to increase advisory fees. In 1970, Congress provided an exception from the prohibition for advisory contracts relating to the investment of assets in excess of $1,000,000, if an appropriate "fulcrum fee" is used. Congress subsequently authorized the Commission to exempt any advisory contract from the performance fee prohibition if the contract is with persons that the Commission determines do not need the protections of that prohibition.

The Commission adopted rule 205–3 in 1985 to exempt an investment adviser from the prohibition against charging a client performance fees in certain circumstances. The rule, when adopted, allowed an adviser to charge performance fees if the client had at least $500,000 under management with the adviser immediately after entering into the advisory contract ("assets under- management test") or if the adviser reasonably believed the client had a net worth of more than $1 million at the time the contract was entered into ("net worth test"). The Commission stated that these standards would limit the availability of the exemption to clients who are financially experienced and able to bear the risks of performance fee arrangements.

In 1998, the Commission amended rule 205–3 to, among other things, change the dollar amounts of the assets under-management test and net worth test to adjust for the effects of inflation since 1985. The Commission revised the former from $500,000 to $750,000, and the latter from $1 million to $1.5 million.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Dodd-Frank Act, among other things, amended section 205(e) of the Advisers Act to state that, by July 21, 2011 and every five years thereafter, the Commission shall adjust for inflation the dollar amount tests included in rules issued under section 205(e). Separately, the Dodd-Frank Act also required that we adjust the net worth standard for an "accredited investor" in rules under the Securities Act of 1933 ("Securities Act") to exclude the value of a person's primary residence.

Information

Pursuant to section 418 of the Dodd-Frank Act, today we are providing notice that the Commission intends to issue an order revising the dollar amount tests of rule 205–3 to account for the effects of inflation. We also are proposing for public comment amendments to rule 205–3 to provide that the Commission will subsequently issue orders making future inflation adjustments every five years. In addition, we are proposing to amend rule 205–3 to exclude the value of a person's primary residence from the determination of whether a person meets the net worth standard required to qualify as a "qualified client." Finally, we propose to modify the transition provisions of the rule to take into account performance fee arrangements that were permissible when they were entered into, so that new dollar amount thresholds do not require investment advisers to renegotiate the terms of arrangements that were permissible when the parties entered into them. These proposals are discussed in more detail below.

A. Order Adjusting Dollar Amount Tests: We intend to issue an order revising the dollar amounts of the assets-under management test and the net worth test in the definition of "qualified client" in rule 205–3. As discussed above, the Commission last revised these dollar amount tests in 1998 to take into account the effects of inflation. At that time, the Commission revised the assets under- management test from $500,000 to $750,000 and revised the net worth test from $1 million to $1.5 million. Pursuant to section 418 of the Dodd-Frank Act, which requires that we revise the dollar amount thresholds of the rule by order not later than July 21, 2011, and every five years thereafter, today we are providing notice that we intend to issue an order to revise the assets-under management and net worth tests of rule 205–3 to $1 million and $2 million respectively.

These revised dollar amounts would take into account the effects of inflation by reference to the historic and current levels of the Personal Consumption Expenditures Chain-Type Price Index ("PCE Index"), which is published by the Department of Commerce. The PCE Index is often used as an indicator of inflation in the personal sector of the U.S. economy. The Commission has used the PCE Index in other contexts, including the determination of whether a person meets a specific net worth minimum in Regulation R under the Securities Exchange Act of 1934 (15 U.S.C. 78a) ("Exchange Act").

B. Proposed Amendments to Rule 205–3:

1. **Inflation Adjustment of Dollar Amount Thresholds.** We also are proposing to amend rule 205–3 under the Advisers Act. We would add a new paragraph (e) stating that the Commission will issue an order every five years adjusting for inflation the dollar amounts of the assets-under management and net worth tests of the rule, as required by the Dodd-Frank Act. Our proposed amendment would specify that the PCE Index will be the inflation index used to calculate future inflation adjustments of the dollar amount tests in the rule. We believe the use of the PCE Index is appropriate because, as discussed above, it is an indicator of inflation in the personal sector of the U.S. economy and is used in other provisions of the Federal securities laws. We also intend to revise paragraph (d) of rule 205–3, which sets forth the assets-under management and net worth tests, to reflect the revised thresholds that we establish by the order discussed above. Finally, we anticipate that, if we adopt these proposed amendments to rule 205–3, we would delegate to our staff the authority to issue inflation adjustment orders every five years in the future. We request comment on the proposed amendments to rule 205–3 concerning the adjustment of the dollar amount thresholds to account for inflation.

2. **Exclusion of the Value of Primary Residence from Net Worth Determination**. We also are proposing to amend the net worth standard in rule 205–3, in the definition of "qualified client," to exclude the value of a natural person's primary residence and debt secured by the property. This change, although not required by the Dodd-Frank Act, is similar to that Act's requirement that we exclude the value of a natural person's primary residence in the definition of "accredited investor" in rules under the Securities Act. The value of a person's residence may have little relevance to an individual's financial experience and ability to bear the risks of performance fee arrangements, and therefore little relevance to the individual's need for the Act's protections from performance fee arrangements. The Commission took a similar approach when it excluded the value of a person's primary residence and associated liabilities from the determination of whether a person is a "high net worth customer" in Regulation R under the Exchange Act 32 and from the determination of whether a natural person has a sufficient level of investments to be considered a "qualified purchaser" under the Investment Company Act. Our proposed amendment would exclude the value of a natural person's primary residence and the amount of debt secured by the property that is no greater than the property's current market value. Therefore a mortgage on the residence would not be included in the assessment of a natural person's net worth, unless the outstanding debt on the mortgage, at the time that net worth is calculated, exceeds the market value of the residence. If the outstanding debt exceeds the market value of the residence, the amount of the excess would be considered

a liability in calculating net worth under the proposed amendments to rule 205–3. We request comment on the proposed exclusion of the value of a person's primary residence from the calculation of a natural person's net worth under rule 205–3.

3. Transition Rules. The proposed amendments would replace the current transition rules section of rule 205–3 with two new subsections to allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. These transition provisions, proposed rules 205–3(c)(1) and (2), are both designed so that restrictions on the charging of performance fees apply to new contractual arrangements and do not apply retroactively to existing contractual arrangements, including investments in companies that are excluded from the definition of an "investment company" under the Investment Company Act by reason of section 3(c)(1) of that Act ("private investment companies"). This approach would minimize the disruption of existing contracts that meet applicable standards at the time the parties entered into the contract.

First, proposed rule 205–3(c)(1) would provide that, if a registered investment adviser entered into a contract and satisfied the conditions of the rule that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of the rule. If, however, a natural person or company that was not a party to the contract becomes a party, the conditions of the rule in effect at the time they become a party would apply to that person or company. This proposed subsection would mean, for example, that if an individual meets the $1.5 million net worth test and enters into an advisory contract with a registered investment adviser, the client could continue to maintain funds (and invest additional funds) with the adviser under that contract even if the net worth test were subsequently raised and he or she no longer met the new test. If, however, another person were to become a party to that contract, the current net worth threshold would apply to the new party when he or she becomes a party to the contract. We request comment on this proposed transition provision.

Second, proposed rule 205–3(c)(2) would provide that, if an investment adviser was previously exempt pursuant to section 203 from registration with the Commission and subsequently registers with the Commission, section 205(a)(1) of the Act would not apply to the contractual arrangements into which the adviser entered when it was exempt from registration with the Commission. This proposed subsection would mean, for example, that if an investment adviser to a private investment company with 50 individual investors was exempt from registration with the Commission in 2009, but then subsequently registered with the Commission because it was no longer exempt from registration or because it chose voluntarily to register, section 205(a)(1) would not apply to the contractual arrangements the adviser entered into before it registered, including the accounts of the 50 individual investors with the private investment company and any additional investments they make in that company. If, however, any other individuals become new investors in the private investment company after the adviser registers with the Commission, section 205(a)(1) would apply to the adviser's relationship with them. We request comment on this proposed transition provision.

C. *Effective and Compliance Dates.* We anticipate that, if we issue the order described above and adopt the rule amendments we are proposing, we will allow an appropriate time period before requiring compliance with the new standards. For rule amendments, the Administrative Procedure Act generally requires at least 30 days prior to the effectiveness of new rules, absent special circumstances.

Conclusion

Comments on the proposed rule should be received on or before July 11, 2011. For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940 - § 275.205–3 Exemption from the compensation prohibition of section 205(a)(1) for investment advisers.

(c) Transition rules. (1) Registered investment advisers. If a registered investment adviser entered into a contract and satisfied the conditions of this section that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of this section; Provided, however, that if a natural person or company who was not a party to the contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions of this section in effect at that time will apply with regard to that person or company.
(2) Registered investment advisers that were previously exempt from registration. If an investment adviser was exempt from registration with the Commission pursuant to section 203 of the Act (15 U.S.C. 80b-3), section 205(a)(1) of the Act will not apply to an advisory contract entered into when the adviser was exempt, or to an account of an equity owner of a private investment company advised by the adviser if the account was established when the adviser was exempt; Provided, however, that section 205(a)(1) of the Act will apply with regard to a natural person or company who was not a party to the contract and becomes a party (including an equity owner of a private investment company advised by the adviser) when the adviser is no longer exempt.
(d) * * *
(1) * * *
(i) A natural person who, or a company that, immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser; (ii) A natural person who, or a company that, the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property; or (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a- 2(a)(51)(A)) at the time the contract is entered into; or
* * * * *
(e) Inflation adjustments. Pursuant to section 205(e) of the Act, the dollar amounts specified in paragraphs (d)(1)(i) and (d)(1)(ii)(A) of this section shall be adjusted by order of the Commission, effective on or about May 1, 2016 and issued approximately every five years thereafter. The adjusted dollar amounts established in such orders shall be computed by: (1) Dividing the year-end value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the United States Department of Commerce, for the calendar year preceding the calendar year in which the order is being issued, by the yearend value of such index (or successor) for the calendar year 1997; (2) For the dollar amount in paragraph (d)(1)(i) of this section, multiplying $750,000 times the quotient obtained in paragraph (e)(1) of this section and rounding the product to the nearest multiple of $100,000; and (3) For the dollar amount in paragraph (d)(1)(ii)(A) of this section, multiplying $1,500,000 times the quotient obtained in paragraph (e)(1) of this section and rounding the product to the nearest multiple of $100,000.

FINRA: Regulatory Notice – Books and Records

Background

The SEC approved FINRA's proposal to adopt rules governing books and records for the consolidated FINRA rulebook. The new rules, FINRA Rules 2268, 4511, 4512, 4513, 4514, 4515, 5340 and 7440(a)(4), are based in large part on NASD Rule 3110, NYSE Rule 440 and NYSE Rule Interpretations 410/01 and 410/02.

The new rules, which are modeled after NASD Rule 3110, NYSE Rule 440 and NYSE Rule Interpretations 410/01 and 410/02, require member firms to make and preserve certain books and records to show compliance with applicable securities laws, rules and regulations—and to enable FINRA and SEC staffs to conduct effective examinations. In general, the new rules streamline, strengthen and clarify existing requirements, as explained below.

Information

FINRA Rule 4511, which is based on the general recordkeeping requirements of NASD Rule 3110(a) and NYSE Rule 440, clarifies that firms are obligated to: (1) make and preserve books and records as required under the rules of FINRA, the Securities Exchange Act (SEA) and the applicable SEA rules; and (2) preserve the books and records required to be made pursuant to the FINRA rules in a format and media that complies with SEA Rule 17a-4.

Additionally, FINRA Rule 4511 requires firms to preserve for a period of at least six years those FINRA books and records for which there is no specified retention period under the FINRA rules or applicable SEA rules. This six-year retention period is a default retention period for those FINRA rules that require firms to preserve certain books and records, but do not specify a retention period, and where there is no retention period specified under the SEA rules. In the absence of contrary guidance in a rule, if the books and records pertain to an account, the retention period is for six years after the date the account is closed; otherwise, the retention period is for six years after such books and records are made.

Customer Account Information: FINRA Rule 4512 requires firms to maintain certain information relating to customer accounts. The new rule is based on existing requirements in NASD Rule 3110(c), with several changes as described below.

The new rule requires firms to maintain the name of the associated person, if any, responsible for the account, rather than requiring firms to maintain the signature of the registered representative introducing the account. Where a member firm designates multiple individuals as being responsible for an account, the firm is required to maintain each of their names and a record indicating the scope of their responsibilities with respect to the account. For purposes of the rule, it is the member firm's obligation to determine whether a particular individual is responsible for the account based on the scope of the individual's activities with respect to that account. The new rule continues to require a firm to maintain the signature of a partner, officer or manager of the firm with respect to an account, but it clarifies that the purpose of this signature is to denote that the account has been accepted in accordance with the firm's policies and procedures for acceptance of accounts. The signature also serves to validate the identity of the named associated person, if any. The rule does not require a partner, officer or manager to provide any particular representations. Further, this signature requirement may be satisfied through the use of electronic means. In this regard, FINRA will consider a valid electronic signature to be any electronic mark that clearly identifies the signatory and is otherwise in compliance with the Electronic Signatures in Global and National Commerce Act (E-Sign Act), the guidance issued by the SEC relating to the E-Sign Act and the guidance provided by FINRA through its interpretive letters, which address electronic approval processes generally.

With respect to a discretionary account maintained by a member firm, the new rule requires firms to obtain the manual dated signature of each named, natural person authorized to exercise discretion in the account. For retention purposes, firms may choose to maintain and preserve the signature record on electronic storage media consistent with SEA Rule 17a-4(f). The new rule no longer requires firms to record the date discretion was granted, or to record the age or approximate age of the customer in connection with exempted securities. The new rule also clarifies that: (1) the requirements of the rule do not apply to investment discretion granted by a customer as to the price at which or the time to execute an order given by the customer for the purchase or sale of a definite dollar amount or quantity of a specified security; and (2) nothing in the rule shall be construed as allowing member firms to maintain discretionary accounts or exercise discretion in such accounts except to the extent permitted under the federal securities laws.

For an account that was opened pursuant to a prior FINRA rule, FINRA Rule 4512 requires member firms to update the information for such an account in compliance with the new rule whenever they update the account information in the course of their routine and customary business, or as required by other applicable laws or rules. FINRA believes that to promote greater consistency and uniformity of account record information, it is necessary that firms update the account information in such a manner.

Finally, the new rule includes the following additional provisions:

It requires firms to preserve: (1) any customer account information that subsequently is updated for at least six years after that update; and (2) the last update to any customer account information, or the original account information if there are no updates, for at least six years after the account is closed.

- It reminds firms that they may be subject to additional recordkeeping requirements under the SEA.
- It also reminds firms of their obligation to comply with the requirements of FINRA Rule 2070 (Transactions Involving FINRA Employees).
- It provides general explanations of the terms "maintain" and "preserve" for purposes of FINRA Rule 4512 only.

Records of Written Customer Complaints: Consistent with existing requirements under NASD Rule 3110, FINRA Rule 4513 addresses a member's obligation to preserve records of written customer complaints at each office of supervisory jurisdiction (OSJ)19 and defines the term "customer complaint" for purposes of this requirement.

The new rule clarifies that the obligation to keep customer complaint records in each OSJ applies only to complaints that relate to that office, including complaints that relate to activities supervised from that office, and provides that firms may maintain the required records at the OSJ or make them promptly available at such office upon FINRA's request.

Lastly, to take into account FINRA's four-year routine examination cycle for certain member firms, FINRA Rule 4513 requires that firms preserve the customer complaint records for a period of at least four years.

Authorization Records for Negotiable Instruments: FINRA Rule 4514 provides, similar to NASD Rule 3110(g), that member firms or associated persons must get a customer's express written authorization before obtaining from a customer, or submitting for payment, a negotiable instrument drawn on the customer's checking, savings, share or similar account. As is the case today, the new rule requires that firms preserve the written authorization and provides that the customer's signature on the negotiable instrument would satisfy the authorization requirement, in which case the member firm is not required to preserve that negotiable instrument.

However, FINRA Rule 4514 clarifies that where the required authorization is separate from the negotiable instrument, firms must preserve that required authorization. The new rule further clarifies that the applicable retention period is three years following the date such authorization expires since a customer authorization may remain in effect beyond three years from the date of the request.

Changes in Account Name or Designation: FINRA Rule 4515, which is modeled after NASD Rule 3110(j) and NYSE Rule 410, requires that, before a customer order is executed, the account name or designation must be placed upon the order form or other similar record for the transaction, and it addresses the approval and documentation procedures for changes in such account name or designation.

FINRA Rule 4515 clarifies that with respect to any change in account name or designation that takes place prior to execution of the trade, the essential facts the principal relied on in approving such change must be documented in writing prior to execution. Firms may use electronic means to satisfy the approval and documentation requirements of FINRA Rule 4515, consistent with the guidance above regarding the use of electronic means to denote acceptance of accounts under FINRA Rule 4512.

Additionally, FINRA Rule 4515.01, which is generally based on NYSE Rule Interpretation 410/02, provides that when accepting orders from investment advisers, the member firm may allow such investment advisers to make allocations on their orders for customers on whose behalf the investment advisers submit the orders, as long as the firm receives specific account designations or customer names from such investment advisers by noon of the next business day following the trading session. FINRA Rule 4515.01 is not limited to block orders, but it only applies where there is more than one customer for any particular order. Moreover, the provision extends to investment advisers that are registered under the Investment Advisers Act or that, but for Investment Advisers Act Section 203(b) or 203A, would be required to register under the Investment Advisers Act. The provision does not extend to accounts handled by individual registered representatives of firms who otherwise exercise discretionary authority over accounts pursuant to NASD Rule 2510.

Lastly, FINRA Rule 4515.01 clarifies that member firms may not knowingly facilitate the allocation of orders from investment advisers in a manner other than in compliance with both (i) the investment adviser's intent at the time of trade execution to allocate shares on a percentage basis to the participating accounts and (ii) the investment adviser's fiduciary duty with respect to allocations for such participating accounts, including but not limited to allocations based on the performance of a transaction between the time of execution and the time of allocation. The "knowingly facilitate" standard means that a broker-dealer may not act recklessly or with knowledge in facilitating an investment adviser's breach of its fiduciary duty to its clients, and compliance with that standard turns on the facts and circumstances.

Predispute Arbitration Agreements: FINRA Rule 2268 requires, among other things, that predispute arbitration agreements contain certain highlighted disclosures so that customers are advised about what they are agreeing to when they sign them. The new rule continues the requirements of NASD Rule 3110(f) and updates the disclosure language to reflect amendments to FINRA Rule 12904, which requires arbitrators to provide an explained decision to the parties in eligible cases if there is a joint request by all parties at least 20 days before the first scheduled hearing date. The disclosure provision regarding explained decisions will apply prospectively to predispute arbitration agreements entered into on or after December 5, 2011, the effective date of FINRA Rule 2268.

Order Audit Trail System (OATS) Recordkeeping Requirements: FINRA Rule 7440(a)(4) sets forth the OATS recordkeeping requirements for member firms that are "Reporting Members," as defined in the OATS rules, for orders received or executed at their trading departments. The new rule is modeled after NASD Rule 3110(h).

Pre-Time Stamping: FINRA Rule 5340 states that pre-time stamping of order tickets in connection with block positioning is contrary to FINRA Rule 4511. This requirement is based on a similar requirement in NYSE Rule Interpretation 410/01.

Conclusion

The rules outlined above take effect on December 5, 2011.

FINRA: Regulatory Notice – Fidelity Bonds

Background

The SEC approved FINRA's proposal to adopt a rule governing fidelity bonds for the consolidated FINRA rulebook. The new rule, FINRA Rule 4360, is based on NASD Rule 3020, taking into account certain requirements under NYSE Rule 319 and its Interpretation. FINRA Rule 4360 (Fidelity Bonds) updates and clarifies the fidelity bond requirements in NASD Rule 3020 and NYSE Rule 319 (and its Interpretation) and better reflects current industry practices. The requirements are set forth in detail below.

Information

FINRA Rule 4360 requires each member firm that is required to join the Securities Investor Protection Corporation (SIPC) to maintain blanket fidelity bond coverage with specified amounts of coverage based on the firm's net capital requirement, with certain exceptions. Such firms must maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability. Firms may apply for this level of coverage with any product that meets these requirements, including the Securities Dealer Blanket Bond (SDBB) or a properly endorsed Financial Institution Form 14 Bond (Form 14).

Most fidelity bonds contain a definition of the term "loss" (or "single loss"), for purposes of the bond, which generally includes all covered losses resulting from any one act or a series of related acts. A payment by an insurer for covered losses attributed to a single loss does not reduce a firm's coverage amount for losses attributed to other, separate acts. A fidelity bond with an aggregate limit of liability caps a firm's coverage during the bond period at a certain amount if a loss (or losses) meets this aggregate threshold. FINRA believes that per loss coverage without an aggregate limit of liability provides firms with the most beneficial coverage since the bond amount cannot be exhausted by one or more covered losses, which means it will be available for future losses during the bond period.

A firm that does not qualify for a fidelity bond with per loss coverage and no aggregate limit of liability must maintain substantially similar fidelity bond coverage in compliance with all other provisions of the rule, provided that the firm maintains written correspondence from two insurance providers stating that the firm does not qualify for such coverage. The firm must retain such correspondence for the period specified by Exchange Act Rule 17a-4(b)(4). A firm's fidelity bond must provide against loss and have Insuring Agreements covering at least the following: fidelity, on premises, in transit, forgery and alteration, securities and counterfeit currency.9 These Insuring Agreements are defined in the fidelity bond forms available to firms. FINRA Rule 4360 modifies the descriptive headings for these Insuring Agreements, in part, from NASD Rule 3020(a)(1) and NYSE Rule 319(d) to align them with the headings in the current bond forms. In addition, FINRA Rule 4360 replaces the specific coverage provisions in the NASD and NYSE rules that permit less than 100 percent of coverage for certain Insuring Agreements (i.e., fraudulent trading and securities forgery) so that coverage for all Insuring Agreements must be equal to 100 percent of the firm's minimum required bond coverage.

A firm's fidelity bond must include a cancellation rider providing that the insurer will use its best efforts to promptly notify FINRA in the event the bond is cancelled, terminated or substantially modified. FINRA Rule 4360 adopts the definition of "substantially modified" in NYSE Rule 319 and incorporates NYSE Rule 319.12's standard that a firm must immediately advise FINRA in writing if its fidelity bond is cancelled, terminated or substantially modified.

Minimum Required Coverage: Each firm subject to the rule must maintain, at a minimum, fidelity bond coverage for any person associated with the firm, except directors or trustees who are not performing acts within the scope of the usual duties of an officer or employee.

A firm with a minimum net capital requirement that is less than $250,000 must maintain minimum coverage of the greater of 120 percent of its required minimum net capital under Exchange Act Rule 15c3-1 or $100,000. The $100,000 minimum coverage requirement modifies the present minimum requirement of $25,000. FINRA believes this increase is warranted since the NASD and NYSE fidelity bond rules have not been materially modified since their adoption more than 30 years ago. Although firms may experience a slight increase in costs for their premiums under the new rule, FINRA believes that the amendments to the fidelity bond minimum requirements are necessary to provide meaningful and practical coverage for losses covered by the bond. Firms with a minimum net capital requirement of at least $250,000 must use a table in FINRA Rule 4360 to determine their minimum fidelity bond coverage requirement. The table is a modified version of the tables in NASD Rule 3020(a)(3) and NYSE Rule 319(e)(i).

The identical NASD and NYSE requirements for members that have a minimum net capital requirement that exceeds $1 million have been retained in FINRA Rule 4360; however, the rule adopts the higher requirements in NYSE Rule 319(e)(i) for a member with a net capital requirement of at least $250,000, but less than $1 million. The entire amount of a firm's minimum required coverage must be available for covered losses and may not be eroded by the costs an insurer may incur if it chooses to defend a claim. Specifically, any defense costs for covered losses must be in addition to a firm's minimum coverage requirements. A firm may include defense costs as part of its fidelity bond coverage, but only to the extent that it does not reduce its minimum required coverage under the rule.

Deductible Provision: FINRA Rule 4360 provides for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a firm. Any deductible amount elected by the firm that is greater than 10 percent of the coverage purchased by the firm19 must be deducted from its net worth in the calculation of its net capital for purposes of Exchange Act Rule 15c3-1. Like the legacy NASD and NYSE rules, if the firm is a subsidiary of another FINRA member firm, this amount may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

Annual Review of Coverage: A member firm (including a firm that signs a multi-year insurance policy) must review, annually as of the yearly anniversary date of the issuance of its fidelity bond, the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the rule. A firm's highest net capital requirement during the preceding 12- month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), is the basis for determining the firm's minimum required fidelity bond coverage for the succeeding 12-month period. The "preceding 12-month period" includes the 12-month period that ends 60 days before the yearly anniversary date of a firm's fidelity bond to provide the firm time to determine its required fidelity bond coverage by the anniversary date of the bond.

A firm that has only been in business for one year and elected the aggregate indebtedness ratio for calculating its net capital requirement may use, solely for the purpose of determining the adequacy of its fidelity bond coverage for its second year, the 15 to 1 ratio of aggregate indebtedness to net capital in lieu of the 8 to 1 ratio (required for broker-dealers in their first year of business) to calculate its net capital requirement. Notwithstanding the above, such member may not carry less minimum fidelity bond coverage in its second year than it carried in its first year.

Exemptions: FINRA Rule 4360 exempts from the fidelity bond requirements firms in good standing with a national securities exchange that maintain a fidelity bond subject to the requirements of such exchange that are equal to or greater than the requirements set forth in the rule. Additionally, consistent with NYSE Rule Interpretation 319/01, FINRA Rule 4360 exempts from the fidelity bond requirements any firm that acts solely as a Designated Market Maker (DMM), floor broker or registered floor trader and does not conduct business with the public.

FINRA Rule 4360 does not maintain the exemption in NASD Rule 3020(e) for a one-person firm. Historically, a sole proprietor or sole stockholder member was excluded from the fidelity bond requirements based upon the assumption that such firms were one-person shops and, therefore, could not obtain coverage for their own acts. FINRA has determined that these firms can and often do acquire fidelity bond coverage, even though it is currently not required, since all claims (irrespective of firm size) are likely to be paid or denied on a facts-and-circumstances basis. In addition, FINRA believes that each Insuring Agreement required by FINRA Rule 4360 has the potential to benefit a one-person firm. Moreover, FINRA believes that requiring all SIPC member firms, regardless of size or structure, to maintain fidelity bond coverage promotes investor protection objectives and mitigates the effects of unforeseen losses.

Conclusion

FINRA Rule 4360 takes effect on January 1, 2012. Member firms subject to the rule (including a firm that signs a multi-year insurance policy) must have a fidelity bond in place as of January 1, 2012, that meets all of the requirements set forth in FINRA Rule 4360. Firms should contact their fidelity bond insurance providers in advance of the effective date of the rule to ensure that necessary updates to their policies are in place as of the effective date.

REGULATORY UPDATE

EBSA: Request for Information Regarding Electronic Disclosure by Employee Benefit Plans

Background

The Department of Labor is reviewing the use of electronic media by employee benefit plans to furnish information to participants and beneficiaries covered by employee benefit plans subject to the Employee Retirement Income Security Act (ERISA). In 2002, the Department adopted standards for the electronic distribution of plan disclosures required under ERISA. The purpose of the review is to explore whether, and possibly how, to expand or modify these standards taking into account current technology, best practices and the need to protect the rights and interests of participants and beneficiaries. This request for information (RFI) solicits views, suggestions, and comments from plan participants and beneficiaries, employers and other plan sponsors, plan administrators, plan service providers, health insurance issuers, and members of the financial community, as well as the general public, on this important issue.

On July 19, 1977, the Department of Labor (Department) adopted general standards governing the delivery of all information required to be furnished to participants, beneficiaries, and other specified individuals under title I of ERISA.1 See 29 CFR 2520.104b–1. These standards require that plan administrators use delivery methods reasonably calculated to ensure actual receipt of such information by plan participants, beneficiaries and other specified individuals. See § 2520.104b– 1(b)(1). For example, in-hand delivery to an employee at his or her worksite is acceptable, as is material sent by first class mail. On April 9, 2002, the Department amended § 2520.104b–1 to establish a "safe harbor" for the use of electronic media to satisfy the general furnishing requirement in § 2520.104b– 1(b). See § 2520.104b–1(c). The specific requirements of the safe harbor are discussed below.

On January 18, 2011, the President issued Executive Order 13563, "Improving Regulation and Regulatory Review." Executive Order 13563 reaffirms the importance of achieving regulatory goals through the most innovative and least burdensome tools available. It also emphasizes the importance of public participation in the regulatory process (in section 2) and retrospective consideration of existing regulatory policies (in section 6). In light of these goals, and in consideration of Administration-wide policies encouraging electronic dissemination of information to the public by federal government agencies consistent with the principles of transparency, participation, and collaboration, EBSA is issuing this RFI to facilitate consideration of its approach to electronic disclosure by employee benefit plans. The Department is aware that electronic disclosure can be as effective as paper based communications, and that it can lower costs and administrative burdens and increase timeliness and accuracy for all involved. The Department also is aware that some of America's workers may not have reasonable access to the Internet, and others may prefer traditional (paper) disclosure methods for important financial interactions regarding their pensions and other employee benefits.

Information

The Department recognizes that there have been substantial changes in technology since over time, both in the workplace and at home, including: The expansion of broadband through cable, fiber optic and wireless networks; hardware improvements to servers and personal computers improving storage, memory, recovery, and computing power; introduction of smart phones, net books and other personal computing devices; and social networking (e.g., LinkedIn, Facebook, and Twitter). At least some evidence suggests that these changes have resulted in a substantial increase in access to and utilization of electronic media. For instance, the 2009 U.S. Census Bureau Current Population Survey (Census) found that 76.7% of the households in the United States have access to the Internet from some location. The Census data further shows that of the 139.1 million private sector workers approximately 111.7 million have access to the Internet from some location. Of the remaining 27.4 million workers who do not have personal access, approximately 10.6 million reside in a household where someone else has Internet access.

Over the past few years, the Department has engaged in various rulemakings and other initiatives involving disclosures to participants and beneficiaries. Examples include the qualified default investment alternative regulation (29 CFR 2550.404c–5), the participant-level fee disclosure regulation (29 CFR 2550.404a–5, 75 FR 64910), the pension benefit statement initiative (FAB 2006–03), the annual funding notice regulation (29 CFR 2520.101–4; FAB 2009–01; proposed § 2520.101–5, 75 FR 70625), and the target date fund initiative (75 FR 73987).

Increasingly, commenters on these initiatives request that the Department take recognition of changes in technology, as other federal regulatory agencies have, and revisit, update, and modernize the electronic disclosure safe harbor to promote electronic disclosure of employee benefit plan information to the greatest extent possible. They argue that such forms of disclosure would be more efficient, less burdensome, and less costly than paper for plans and, therefore, participants.

Not everyone, however, agrees that electronic disclosure is appropriate for all participants and beneficiaries or for all disclosures. Some caution against broadening the electronic disclosure safe harbor, arguing that some workers do not have reasonable Internet access, or that they simply prefer paper over electronically disclosed materials even when they have access.

In light of these differing views and the significance of the issues surrounding the use of electronic disclosure, the Department has decided to explore whether and how to expand or modify the current standards under ERISA applicable to the electronic distribution of required plan disclosures. To that end, the Department, through this RFI, is soliciting the views of the public on this important issue. Set forth below are a list of questions. In considering the questions set forth in this RFI, commenters are encouraged to take into account the following information:

Electronic Disclosure Under ERISA

As noted above, on April 9, 2002, the Department established its electronic disclosure safe harbor. See § 2520.104b-1(c). As a safe harbor, § 2520.104b–1(c) is not the exclusive means for using electronic media to satisfy the requirements of § 2520.104b–1(b)(1). Plan administrators may find that other procedures will allow them to meet the general delivery requirements of § 2520.104b–1. However, following the conditions of the safe harbor provides assurance that the general delivery requirements under § 2520.104b–1(b)(1) have been satisfied. The safe harbor is available only if: (1) The plan administrator takes appropriate and necessary measures reasonably calculated to ensure that the system for furnishing documents results in actual receipt of transmitted information and protects the confidentiality of personal information relating to the individual's accounts and benefits; (2) the electronically delivered documents are prepared and furnished in a manner that is consistent with the style, format and content requirements applicable to the particular document; (3) notice is provided to each participant, beneficiary or other individual, in electronic or nonelectronic form, at the time a document is furnished electronically, that apprises the individual of the significance of the document when it is not otherwise reasonably evident as transmitted and of the right to request and obtain a paper version of such document; and (4) upon request, the participant, beneficiary or other individual is furnished a paper version of the electronically furnished documents. § 2520.104b–1(c)(1)(i) through (iv).

The safe harbor applies only for two categories of individual recipients. The first category consists of participants who have the ability to effectively access documents furnished in electronic form at any location where the participant is reasonably expected to perform his or her duties as an employee and with respect to whom access to the employer's or plan sponsor's electronic information system is an integral part of those duties. See § 2520.104b–1(c)(2)(i). The second category consists of participants, beneficiaries and other persons who are entitled to documents under title I of ERISA, but who do not fit into the first category. For this category, the safe harbor assumes the utilization of electronic information systems beyond the control of the plan or plan sponsor. The current safe harbor, therefore, provides that the second category of individuals must affirmatively consent to receive documents electronically. See § 2520.104b–1(c)(2)(ii)(A). The safe harbor relief is not available with respect to these individuals in the absence of such consent.

In general, the affirmative consent condition requires plans to ensure that an individual has affirmatively consented, in electronic or nonelectronic form, to receiving documents through electronic media and has not withdrawn such consent. Alternatively, in the case of documents to be furnished through the Internet or through other electronic communication networks, the individual must have affirmatively consented or confirmed consent electronically, in a manner that reasonably demonstrates the individual's ability to access information in the electronic form that will be used to provide the information that is the subject of the consent, and must have provided an address for the receipt of electronically furnished documents. In addition, prior to consenting, the individual must be provided, in electronic or non-electronic form, a clear and conspicuous statement indicating: (1) The types of documents to which the consent would apply; (2) that consent can be withdrawn at any time without charge; (3) the procedures for withdrawing consent and for updating the participant's, beneficiary's or other individual's address for receipt of electronically furnished documents or other information; (4) the right to request and obtain a paper version of an electronically furnished document, including whether the paper version will be provided free of charge; and (5) any hardware and software requirements for accessing and retaining the documents. Further, following consent, if a change in such hardware or software requirements creates a material risk that the individual will be unable to access or retain electronically furnished documents, the individual: (1) Is provided with a statement of the revised hardware or software requirements for access to and retention of electronically furnished documents; (2) is given the right to withdraw consent without charge and without the imposition of any condition or consequence that was not disclosed at the time of the initial consent; and (3) again consents in accordance with the requirements above. See § 2520.104b– 1(c)(2)(ii).

Electronic Disclosure Under the Internal Revenue Code

The Department of Treasury and the Internal Revenue Service (IRS) have issued guidance relating to the use of electronic media of notices or elections with respect to a retirement plan. In 2000, final regulations were issued relating to the use of electronic media for the delivery of certain participant notices and consents that are required to be provided in connection with distributions from retirement plans. In 2003, the Department of Treasury and IRS published final regulations under section 4980F under the Internal Revenue Code (Code) that also apply for purposes of section 204(h) of ERISA (2003 section 4980F regulations). Under Q&A–13(c) of § 54.4980F–1, notice required under section 4980F of the Code or section 204(h) of ERISA (section 204(h) notice) may be provided electronically if certain requirements are satisfied. The section 204(h) notice must actually be received by the applicable individual or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing the section 204(h) notice results in actual receipt of the notice. In addition, the plan administrator must provide the applicable individual with a clear and conspicuous statement that the individual has a right to receive a paper version of the section 204(h) notice without the imposition of fees and, if the individual requests a paper copy of the section 204(h) notice, the paper copy must be provided without charge.

The 2003 section 4980F regulations also provide a safe harbor method at 26 CFR 54.4980F–1, Q&A–13(c)(3), for delivering a section 204(h) notice electronically, which is substantially the same as the consumer consent rules of E–SIGN (described below under the heading "Electronic Signatures in Global and National Commerce Act"). On October 20, 2006, the Department of Treasury and IRS published final regulations under the Code setting forth standards for electronic systems that make use of an electronic medium to provide a notice to a recipient, or to make a participant election or consent, generally with respect to a retirement plan, an employee benefit arrangement, or an individual retirement plan. These regulations provide two methods by which such plans or arrangements are permitted to provide an applicable notice to a recipient through the use of an electronic medium. Under the first method, an applicable notice is permitted to be provided electronically after the recipient consents to the electronic delivery of the notice (consumer consent method). The consumer consent method reflects the consumer consent requirements in E–SIGN. The second method does not require consent by the recipient, but when the applicable notice is provided, the recipient must be advised that he or she may request and receive the applicable notice in writing at no charge (alternative method). In addition, any recipient of the notice must be "effectively able" to access the electronic medium used to provide the notice. See generally 26 CFR 1.401(a)–21(b) and (c).

These regulations also modified the 2003 section 4980F regulations to require that a section 204(h) notice comply with the regulations under § 1.401(a)–21. The current section 4980F regulations retain the requirement in the 2003 section 4980F regulations that the section 204(h) notice actually be received by the applicable individual or that the plan administrator take appropriate and necessary measures reasonably calculated to ensure that the method for providing the section 204(h) notice results in actual receipt. See 26 CFR 54.4980F–1, Q&A–13(c)(1).

Electronic Disclosure of Proxy Materials and Prospectuses Under Securities Law

In 2007, the Securities and Exchange Commission (SEC) amended its rules under the Securities Exchange Act of 1934 to provide a method to furnish proxy materials by posting them on an Internet Web site and providing shareholders with notice of the availability of the proxy materials. In 2009, the SEC adopted amendments permitting a person to satisfy its mutual fund prospectus delivery obligations under the Securities Act of 1933 by sending or giving investors a summary prospectus and providing the statutory prospectus on an Internet Web site. Under both rules, copies of the documents must be sent at no charge to shareholders requesting such copies. See 17 CFR 240.14a–16; 17 CFR 230.498. The SEC has also previously provided interpretive guidance on the use of electronic media to deliver information under the federal securities law.

2006 ERISA Advisory Council Working Group Report on Prudent Investment Process

On August 9, 2006, and September 21, 2006, a working group of the ERISA Advisory Council held a hearing on numerous issues pertaining to the management of plan assets, including the use of electronic media for disclosures required by regulations under section 404(c) of ERISA. Thirteen witnesses testified at this hearing. In response to this hearing, the working group issued the "Report of the Working Group on Prudent Investment Process." With respect to the Department's electronic disclosure safe harbor as applied to defined contribution pension plans, the Report states:

> The Working Group would like to recommend to the Department of Labor that the Department should reconsider its rules for electronic transfer of notices and the delivery of 'sufficient information.' The Working Group heard extensive testimony regarding the growth of the internet and its use by plan participants. Access to and use of the internet has grown significantly since the DOL first considered electronic delivery. The Working Group recommends that the electronic delivery standard should be relaxed from the 'integral part of the employee's duties' standard currently employed to a 'reasonable access' standard.

2007 ERISA Advisory Council Working Group Report on Participant Benefit Statements

On July 12, 2007, and September 18, 2007, a working group of the ERISA Advisory Council held a public hearing on the pension benefit statement requirements under section 105 of ERISA, as amended by section 508 of the Pension Protection Act of 2006 Public Law 109–280, 120 Stat. 949–952.

Thirteen witnesses testified at this hearing. In response to this hearing, the working group issued the "Report of the Working Group on Participant Benefit Statements." In this Report, the Working Group recommended that "the Department of Labor should update its regulations regarding electronic communication to a 'reasonable access' standard as in the Department of Treasury safe harbor regulation in recognition of the continued advancement in Web-based communication and the increase in its use by participants." In support of this recommendation, the Report explains:

Following an animated discussion, the Working Group came to a consensus that although the American workforce is becoming more computer literate, it is not yet appropriate to make electronic delivery of participant statements the norm. In addition to access and ability to use issues, many participants who are computer literate are better served with paper when managing their plan asset. However, the Treasury rules regarding communication provide incentive for plan sponsors to migrate to electronic delivery. In any event, the new regulations should reexamine the use of electronic communication for benefit statements to recognize the changes in technology and the participant group's use of it.

2009 ERISA Advisory Council Report on Promoting Retirement Literacy and Security by Streamlining Disclosures

On July 23, 2009, and September 15, 2009, the ERISA Advisory Council, in furtherance of its focus on the issue of promoting retirement literacy and security by streamlining disclosures to participants and beneficiaries, held a public hearing to study the efficacy of ERISA's reporting and disclosure schemes, as well as problems and costs related to such disclosures.

Approximately 18 witnesses testified at this hearing. Upon conclusion of the hearing, the full ERISA Advisory Council reached consensus and issued a report entitled "Promoting Retirement Literacy and Security by Streamlining Disclosures." In this Report, the Council recommended that:

[T]he Department of Labor permits plan administrators to rely on the IRS Regulations in order to comply with ERISA's disclosure requirements. The Council believes that the IRS Regulations will adequately protect the rights of those participants who are actively employed because it will generally be very simple for administrators to determine whether active employees have reasonable access to the electronic medium used to furnish the disclosure. The Council believes that administrators will not furnish those individuals who are not working actively— such as retirees or beneficiaries—with electronic disclosure unless the administrator has a working electronic mail address for such individuals. In that way, participants who are not actively employed and plan beneficiaries will be protected.

Electronic Signatures in Global and National Commerce Act

The Electronic Signatures in Global and National Commerce Act (E–SIGN), 17 U.S.C. 7001–7021, generally provides that electronic records and signatures have the same legal effect as their paper counterparts. When a statute, regulation, or other rule of law requires that information relating to a transaction be provided or made available to a consumer in writing, section 101(c) of E–SIGN requires that the consumer must first affirmatively consent to receive the information electronically in a manner that reasonably demonstrates the consumer's ability to access the information in electronic form. 17 U.S.C. 7001(c). However, section 104(d)(1) of E–SIGN, 17 U.S.C. 7004(d)(1), authorizes a Federal regulatory agency to exempt, without condition, a specified category or type of record from the consumer consent requirements in section 101(c). The agency may issue an exemption only if it is necessary to eliminate a substantial burden on electronic commerce and will not increase the material risk of harm to consumers.

Request for Information

The purpose of this RFI is to solicit views, suggestions and comments from plan participants and beneficiaries, employers and other plan sponsors, plan administrators, plan service providers, health insurance issuers, and members of the financial community, as well as the general public on whether, and possibly how, to expand or modify the Department's current electronic disclosure safe harbor. To facilitate consideration of the issues, the Department has set forth below a number of questions. Respondents need not answer every question, but should identify, by its number, each question addressed. Interested persons are also encouraged to address any other matters they believe germane to the general topic of the RFI.

Access and Usage Questions

1. What percentage of people in this country have access to the Internet at work or home? Of this percentage, what percentage have access at work versus at home? Does access vary by demographic groups (*e.g.,* age, socioeconomic, race, national origin, etc.)?
2. What percentage of participants and beneficiaries covered by an ERISA plan have access to the Internet at work or home? Of this percentage, what percentage has access at work, at home, or both? Does access vary by demographic groups (*e.g.,* age, socioeconomic, race, national origin, etc.)? What percentage of participants and beneficiaries uses the Internet to access private information such as personal bank accounts?
3. What percentage of pension benefit plans covered by ERISA currently furnish some or all disclosures required by ERISA electronically to some or all participants and beneficiaries covered under these plans? Please be specific regarding types of plans (*e.g.,* single employer plans versus multiemployer plans, defined benefit pension plans versus defined contribution pension plans, etc.), types of participants and beneficiaries (e.g., active, retired, deferred vested participants) and types of disclosures (*e.g.,* all required title I disclosures versus select disclosures).
4. What percentage of employee welfare benefit plans covered by ERISA currently furnish some or all disclosures required by ERISA electronically to some or all participants and beneficiaries covered under these plans? Please be specific regarding types of welfare plans (e.g., health, disability, etc.), types of participants and beneficiaries (*e.g.,* active employees, retirees, COBRA Qualified Beneficiaries, etc.) and types of disclosures (*e.g.,* all required title I disclosures versus select disclosures).
5. What are the most common methods of furnishing information electronically (*e.g.,* e-mail with attachments, continuous access Web site, etc.)?
6. What are the most significant impediments to increasing the use of electronic media (*e.g.,* regulatory impediments, lack of interest by participants, lack of interest by plan sponsors, access issues, technological illiteracy, privacy concerns, etc.)? What steps can be taken by employers, and others, to overcome these impediments?
7. Is there evidence to suggest that any increase in participant and beneficiary access to, and usage of, the Internet and similar electronic media in general equates to an increased desire or willingness on the part of those participants and beneficiaries to receive employee benefit plan information electronically? If so, what is it?
8. Are there any new or evolving technologies that might impact electronic disclosure in the foreseeable future?

General Questions

9. Should the Department's current electronic disclosure safe harbor be revised? If so, why? If not, why not?
10. If the safe harbor should be revised, how should it be revised? Please be specific.
11. Should a revised safe harbor have different rules or conditions for different types of employee benefit plans (*e.g.,* pension versus welfare plans)? If so, why and what differences?
12. Should a revised safe harbor have different rules or conditions for different types of disclosures (*e.g.,* annual funding notice, quarterly benefit statement, COBRA election notice, etc.)? If so, why and what differences?
13. Should a revised safe harbor have different rules or conditions for different recipients entitled to disclosures (active employees, retirees, COBRA Qualified Beneficiaries, etc.)? If yes, why, and how should the rules or conditions differ?
14. To what extent should the Department encourage or require pension and welfare benefit plans to furnish some or all disclosures required under title I of ERISA through a continuous access Web site(s)? In responding to this question, please address whether and how frequently participants and beneficiaries should be notified of their ability to access benefit information at the Web site(s) and the most appropriate means to provide such notice. For example, should participants and beneficiaries receive a monthly notification of their ability to access benefit information or should they receive a notification only when an ERISA-required disclosure is added to the Web site? How should such notifications be furnished (*e.g.,* paper, email, etc.)? Please also address what steps would be needed to ensure that participants and beneficiaries understand how to request and receive paper copies of the disclosures provided on the Web site(s).

15. Who, as between plan sponsors and participants, should decide whether disclosures are furnished electronically?

    For example, should participants have to opt into or out of electronic disclosures? See Question 26.

16. Should a revised safe harbor contain conditions to ensure that individuals with disabilities are able to access disclosures made through electronic media, such as via continuous access Web sites? If so, please describe the conditions that would be needed. Also, please identify whether such conditions would impose any undue burdens on employee benefit plans, including the costs associated with meeting any such conditions. What burden and difficulty would be placed on employees with disabilities if the Web sites and/or other electronic communication were not accessible?

Technical Questions

17. If a plan furnishes disclosures through electronic media, under what circumstances should participants and beneficiaries have a right to opt out and receive only paper disclosures?

18. The Department's current regulation has provisions pertaining to hardware and software requirements for accessing and retaining electronically furnished information. In light of changes in technology, are these provisions adequate to ensure that participants and beneficiaries, especially former employees with rights to benefits under the plan, have compatible hardware and software for receiving the documents distributed to their non-work e-mail accounts?

19. Some have indicated that the affirmative consent requirement in the Department's current electronic disclosure safe harbor is an impediment to plans that otherwise would elect to use electronic media. How specifically is this requirement an impediment? Should this requirement be eliminated? Is the affirmative consent requirement a substantial burden on electronic commerce? If yes, how? Would eliminating the requirement increase a material risk of harm to participants and beneficiaries? If yes, how? See section 104(d)(1) of E–SIGN.

20. In general, the E–SIGN Act permits electronic disclosure of health plan materials but does not apply to cancellation or termination of health insurance or benefits electronically. Are there special considerations the Department should take into account for group health plan disclosures (including termination of coverage and privacy issues)?

21. Many group health plan disclosures are time-sensitive (e.g., COBRA election notice, HIPAA certificate of creditable coverage, special enrollment notice for dependents previously denied coverage under the ACA, denials in the case of urgent care claims and appeals). Are there special considerations the Department should take into account to ensure actual receipt of time-sensitive group health plan disclosures?

22. Do spam filters and similar measures used by non-workplace (personal) e-mail accounts, pose particular problems that should be taken into consideration?

23. What is the current practice for confirming that a participant received a time-sensitive notice that requires a participant response?

24. What are current practices for ensuring that the e-mail address on file for the participant is the most current email address? For example, what are the current practices for obtaining and updating e-mail addresses of participants who lose their work e-mail address upon cessation of employment or transfer to a job position that does not provide access to an employer provided computer?

SEC: Speech by SEC Chairman Mary L. Shapiro – Remarks Before the Investment Company Institute's General Membership Meeting

Background

On May 6, 2011, SEC Chairman Mary L. Shapiro spoke at the general membership meeting of the Investment Company Institute. Chairman Shapiro spoke about the events that happened on May 6, 2010 as stock prices began to fall with almost unprecedented speed: a Dow that had already lost almost 4 percent on the day plunged almost 600 points in about five minutes. That left the nation's most prominent stock index down nearly 1,000 points from the previous day's close. And then, just as suddenly, the markets reversed themselves, recovering almost 600 points in the minutes that followed. Between 3 and 4 p.m., 17 million trades were executed. In that time, investors suffered steep losses, and respected companies saw their reputations harmed as stock values evaporated almost instantly. Chairman Shapiro has stated that the significance of May 6 is greater than the investor harm caused by these wild swings in prices – it lies in the significant blow to investor confidence this volatility delivered, as well. Because, while every investor accepts financial risk as a fact of life, they operate under the assumption that America's markets are structurally sound – that the funds you represent and the investors you advise could confidently entrust their capital to the world's most sophisticated financial markets.

Below is an excerpt from her speech which highlights the actions taken by the SEC and what can be expected going forward.

Information - What Happened?

On May 6, a combination of algorithmic trading systems and rational trading behavior drove a broad liquidity crisis that caused unprecedented gyrations in the equities markets.

The first domino to fall was the broad index level in the E-Mini S&P 500 futures product, which experienced a sudden liquidity crisis. The impact of this liquidity crisis was then transmitted almost instantaneously to the securities markets through cross-market trading strategies.

The next phase of the disruption was a liquidity crisis in hundreds of individual securities. At the worst end of the spectrum, more than 300 securities suffered declines of more than 60 percent from their 2:40 p.m. prices. Ultimately, more than 20,000 trades were broken, many of which were executed at prices of a penny per share.

As noted in the joint SEC-CFTC Staff Report released last September, this liquidity shortage and subsequent volatility were exacerbated when the automated trading systems of many large securities market participants temporarily paused in reaction to the sudden price declines. Some market participants widened their quoted spread, others offered reduced liquidity, and a significant number withdrew completely from the markets. All of these were rational responses by individual market participants. But, in aggregate, they were extremely disruptive at a moment when the markets desperately needed liquidity.

The resulting extreme price moves across hundreds of securities at once were unprecedented in modern U.S. equity market history. The SEC's response, launched in the immediate aftermath of the event, continued as we worked to bolster our markets and restore the confidence of investors:

- The pilot circuit breaker program first applied to stocks listed in the S&P 500 last June has since been extended. It now applies to all stocks in the Russell 1000 Index, to more than 300 ETFs and to other exchange traded products.
- Last September, the Commission approved exchange and FINRA rules designed to bring order and transparency to the process of breaking "clearly erroneous" trades.
- In November, the Commission approved exchange rules that enhance the quotation standards for market makers and eliminate "stub quotes." Executions against stub quotes represented a significant proportion of the trades that were executed at extreme prices on May 6th and subsequently broken.
- Also last November, the Commission adopted a new rule requiring broker-dealers with market access to put in place risk management controls and supervisory procedures on a pre-trade basis – effectively banning naked access.

The lengthy and laborious detailed investigation of May 6 also underscored the need for a better way to reconstruct trades. That is why the SEC proposed the creation of a consolidated audit trail – a system that would provide the SEC and other regulators direct, timely access to data on all orders in the national market system, from all participants across all markets. This would allow us to rapidly reconstruct trading activity and quickly analyze both suspicious trading behavior and unusual market events. We proposed creation of such a system last May, and we are considering the many comments received as the staff prepares its recommendations to the Commission.

Proposed Volatility Plan: In addition to these actions, the CFTC and SEC asked the recently-established expert Advisory Committee on Emerging Regulatory Issues to consider the market disruption and make recommendations related to market structure issues that may have contributed to the volatility of that day

In April, the exchanges and FINRA, working with Commission staff, proposed a major expansion and enhancement of the pilot circuit breaker program aimed at addressing extraordinary volatility. This proposal, dubbed the Volatility Plan, which is available on the Commission's website, offers many potentially important changes.

- First, the proposed plan would expand the pilot circuit breaker program in two significant respects. It would extend circuit breaker protection to all U.S.-listed equities. And, it would apply circuit breakers during the opening and closing periods of the day, which currently are not covered by the pilot program.
- Second, it would add a "limit up-limit down" mechanism. This would address weaknesses in the pilot program that permit a single erroneous trade to trigger a full trading pause.
- Finally, the Volatility Plan proposes cutting in half the price parameters that would trigger a pause, from 10 percent to 5 percent. This would greatly reduce the scope for sudden price moves.

Key Considerations: In thinking through our next steps, we need to consider several important questions:

- First, what is "excessive short-term volatility?" Put another way, what level of volatility is appropriate in continuous trading, and at what point should circuit breakers or limit up/limit down take effect?
- Second, how does excessive volatility affect – and how is it affected by – different market participants, including traders, investors, individual securities and mutual funds?
- And finally, should high-frequency traders, who often derive significant benefit from their role as de facto market makers, also have the obligations of market makers as well as other responsibilities with respect to the impact of their technology and trading strategies on the markets?

These questions touch on fundamental public policy objectives for the U.S. equity markets and deserve a robust discussion. And, in answering them, I believe that we must be guided by the objectives of promoting capital formation and – critically – protecting the interests of investors.

Excessive Volatility: Regarding the first question, it is possible to make an argument that occasional instances of extreme volatility are simply a fact of life for the equity markets. News stories, earnings reports and other events that affect market valuations should get priced in quickly. But the events of May 6 crossed an important threshold. First, tremendous harm was done that day. And second, rather than resulting from an irregular but unavoidable occurrence, this harm resulted primarily from a technical market structure problem – not a "real" change in valuation or other fundamentals of the issuers.

Approximately two-thirds of the intra-day decline on May 6 was reversed within minutes, as buyers rushed in to take advantage of the drop. Since that day, we have heard over and over again from fundamental investors that, given the opportunity, they would have been strong buyers during the decline. But during the decline, sell orders simply outpaced buyers' ability to trade. Indeed, the speed of the broad decline caused many market participants to fear that a cataclysmic event – of which they were not yet aware – had occurred. This further widened the gap between short term supply and demand as investors stayed on the sidelines, until their fears could be allayed.

While it's difficult to determine the exact point at which short-term volatility becomes "excessive," it is nonetheless a critical question and one that demands our attention.

Different Exposure: The answer to the second question – how excessive volatility affects different entities – is not difficult to discover. But it needs to be underscored because the answer points us toward a possible solution. Excessive volatility harms a listed company by increasing the perceived risk of investing in its stock. And many individual investors were harmed when they relied on the integrity of the market prices, suffering losses when their orders were executed at temporarily disrupted prices.

On the other hand, many short-term traders, whose revenues are typically driven by volatility and volume, enjoyed a highly profitable day. The importance of these traders' actions can perhaps best be understood by comparing their actions to those of their predecessors during the "market crash" on May 28, 1962. There are a number of similarities between 1962 and 2010. For example, neither of these severe price moves could be readily explained by a particular news event. On both days, some market data systems were overwhelmed by the heavy volume. And, in both instances, the sudden declines struck at investor confidence, leading them to question the stability and integrity of the equity markets. But the differences between those two events are even more striking.

First, the magnitude of the declines, both at the broad market index level and for worst-hit individual securities, was much more severe in 2010 than 1962. In '62, the Dow declined to intraday lows of 6.3 percent compared to 9.9 percent on May 6. And one of the worst-hit individual securities in 1962 dropped 9.3 percent in a 12-minute period. In 2010, many securities lost 100 percent of their value in a matter of seconds. Perhaps the biggest difference – and one that may help explain the difference in the magnitudes of the declines – is the volume and trading behavior of the professional traders who were expected to be the primary liquidity providers.

In '62, the specialists who were then the primary liquidity providers, represented approximately 17 percent of market volume and were net buyers in aggregate during the decline. In 2010, the high frequency traders who are today's liquidity providers represented well more than 50 percent of market volume and were net aggressive sellers during the broad index price decline. High frequency traders turned what was a very down day for many investors into a very profitable one for themselves by taking liquidity rather than providing it. I think their activity that day should cause us to thoroughly examine their current role.

HFT Obligations and Other Quality–of-Market Concerns: The final question is more difficult. Do the Commission's mandates to protect investors and promote capital formation justify the imposition of trading obligations or other responsibilities on high frequency traders? Naturally, we are mindful of the unintended consequences that could result from imposing such obligations. For example, imposing significant obligations for market quality on some firms, but leaving other firms free to operate without those obligations, could create an unfair playing field and, in the end, do little to promote market quality.

In addition, we need to assess the entire regulatory structure surrounding high frequency trading firms and their algorithms. Do current regulations reflect their impact on trading? And, are their algorithms programmed to operate properly in stressed market conditions?

As we continue to examine the options of imposing enhanced obligations on high frequency traders, we are considering other changes, as well, that may offer investors a measure of needed protection in the near term.

The Volatility Plan proposed by FINRA and the exchanges would, for example, serve to limit algorithmic trading of the sort that added momentum to the price decline on May 6.

In particular, reducing the trigger to 5 percent is designed to be more effective in halting non-fundamental runs on individual stocks and even the broader market. The proposed plan would have made a real difference on May 6. The current price parameters in the pilot circuit breaker program are set at a 10 percent price move within a five minute period. Yet at least 98 percent of the trades and 84 percent of the securities involved in the market disruption on May 6 would not have been affected by the current level of circuit breaker protection.

Under the proposed Volatility Plan, a price move that hits the percentage parameters would trigger a brief "limit state" in which a liquidity imbalance would have 15 seconds to correct itself "naturally." In a down market, for example, the limit state would provide 15 seconds for buyers to respond to a sell imbalance and stop a cascade of prices. If the plan is approved, this brief period could allow minor liquidity imbalances to be corrected without the need for the full trading pause.

Also, if the plan is approved, these pauses could provide a period in which market participants have an opportunity to assess the market and decide whether and at what prices they wish to buy or sell. The result should be trading driven less by momentum-seeking algorithms and more by rational trading based on fundamentals. Setting appropriate price parameters is also important as we work with the CFTC and the securities and futures markets to update the existing index-wide circuit breakers that apply to both the securities and futures markets. These index circuit breakers have never been triggered at their current price parameters, which require a broad market price move of at least 10 percent from the previous day's close. The index circuit breakers need updating to reflect current levels of volatility, as well as to work smoothly with the proposed Volatility Plan.

Another contributing factor to May 6 was the fragmentation of trading across a great many different venues, including many dark venues. On normal days, the volume of orders handled by these venues, which include dark pool ATSs and internalizing broker-dealers, exceeds 30 percent of total volume in U.S.-listed stocks. During the worst of the disruption on May 6, their share of volume plummeted to 11 percent as liquidity disappeared in the dark venues and sell orders suddenly were diverted to the public markets. Our staff is considering whether the respective rules applicable to public and dark venues appropriately reflect their contribution to price discovery and stability.

Finally, we need to look beyond May 6, at other issues that could lead to structural breakdown. One imperative is ensuring that the technology systems of exchanges and other key market participants are sufficiently robust to handle today's trading practices, particularly during volatile periods when volume and message traffic can skyrocket. I believe, for example, that the SEC should consider making compliance with the SEC's Automation Review Policies mandatory – and as such require market participants to meet adequate standards for the capacity, resiliency, and security of their automated systems. These rules could apply to exchanges, alternative trading systems handling appreciable volume, clearing agencies, depositories and securities information processors.

FDIC: Proposed Rule – Interest on Deposits; Deposit Insurance Coverage

Background

Effective July 21, 2011, the statutory prohibition against the payment of interest on demand deposits will be repealed pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the DFA). In light of this, the FDIC proposes to rescind regulations that have implemented this prohibition with respect to state chartered nonmember (SNM) banks. Because the regulations include a definition of "interest" that may assist the FDIC in interpreting a recent statutory amendment that provides temporary, unlimited deposit insurance coverage for noninterest-bearing transaction accounts, the FDIC also proposes to retain and move the definition of "interest" into the deposit insurance regulations.

Section 343 of the DFA amended section 11(a)(1) of the Federal Deposit Insurance Act, 12 U.S.C. 1821(a)(1), to provide full insurance coverage for depository institution noninterest bearing transaction accounts from

December 31, 2010, through December 31, 2012. Section 627 of the DFA repealed the statutory prohibition against the payment of interest on demand deposits, effective one year from the date of the DFA's enactment July 21, 2011.

In light of the prospective repeal of the demand deposit interest prohibition, the FDIC proposes to rescind 12 CFR Part 329, the regulation which implements that prohibition with respect to SNM banks, to be effective on the same date as the statutory repeal, July 21, 2011. At the same time, however, a regulatory definition of the term "interest" will still be useful in interpreting the requirements of section 343 of the DFA providing temporary, unlimited deposit insurance coverage for noninterest-bearing transaction accounts. For this reason, the FDIC proposes, as part of this same rulemaking, to transfer the definition of "interest" currently found at 12 CFR 329.1(c) to Part 330, specifically the definitions section at 12 CFR 330.1. The FDIC also specifically solicits comment on whether other parts of Part 329 could also prove useful and therefore should be moved into Part 330 as well. For example, section 329.103 provides an interpretive rule that defines what constitutes a "premium" which may prove useful in determining whether an account qualifies as a noninterest bearing transaction account. The FDIC seeks comment on every aspect of this proposed rule.

Information

A. Solicitation of Comments on Use of Plain Language. Section 722 of the Gramm-Leach- Bliley Act, 1471 (Nov. 12, 1999), requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. We invite your comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

B. Regulatory Flexibility Act. The Regulatory Flexibility Act (RFA) requires that each federal agency either certify that a proposed rule would not, if adopted in final form, have a significant economic impact on a substantial number of small entities or prepare an initial regulatory flexibility analysis of the rule and publish the analysis for comment. For purposes of the RFA analysis or certification, financial institutions with total assets of $175 million or less are considered to be "small entities." The FDIC hereby certifies pursuant to 5 U.S.C. 605(b) that the NPR, if adopted, will not have a significant economic impact on a substantial number of small entities. This is because the FDIC already applies the Part 329 definition of "interest" for purposes of determining whether an account qualifies for full deposit insurance coverage as a noninterest bearing transaction account. The FDIC is only proposing to transfer the definition from Part 329 to Part 330 because the former regulation will become moot on July 21, 2011, pursuant to section 627 of the DFA and its repeal of the statutory ban on the payment of interest on demand deposits. There will therefore be no significant economic impact on a substantial number of small entities as a result of this change.

Conclusion

For the reasons set forth in the preamble, and under the authority of 12 U.S.C. 1813, the FDIC proposes to amend chapter III of title 12 of the Code of Federal Regulations as follows:

PART 329 – [REMOVED]

1. Part 329 is removed and reserved.

PART 330 – DEPOSIT INSURANCECOVERAGE

2. The authority for part 330 continues to read as follows: 12 U.S.C. 1813(l), 1813(m), 1817(i), 1818(q), 1819(Tenth), 1820(f), 1821(a), 1822(c).
3. In § 330.1, paragraphs (k) through (r) are redesignated as paragraphs (l) through (s), respectively, and new paragraph (k) is added to read as follows:

§ 330.1 Definitions.

* * * * *

(k) Interest, with respect to a deposit, means any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit. A bank's absorption of expenses incident to providing a normal banking function or its forbearance from charging a fee in connection with such a service is not considered a payment of interest.

IRS: Enforcement Begins Regarding New Return Prepared Rules (IR-2011-47)

Background and Information

The Internal Revenue Service is taking steps to stop tax preparers with criminal tax convictions or permanent injunctions from preparing tax returns. This is just one of several recent moves to improve the quality and oversight of the tax preparation industry. More than 700,000 tax preparers nationwide have registered with the IRS and obtained Preparer Tax Identification Numbers (PTINs). This nine-digit number must be used by paid tax return preparers on all returns or claims for refund. Paid preparers must renew their PTINs annually to legally prepare tax returns.

"We owe it to all taxpayers and the many honest tax return preparers to remove the relatively small number of bad actors from the tax preparation industry," said Doug Shulman, IRS Commissioner. "Just one unscrupulous tax return preparer can cause a lot of financial damage to both taxpayers and the tax system." By comparing the new PTINs with a database managed by the IRS' Office of Professional Responsibility, the IRS was able to identify 19 tax preparers who applied for PTINs and either failed to disclose a criminal tax conviction or have been permanently enjoined from preparing tax returns. A permanent injunction is a court order used by the Department of Justice to stop a preparer who repeatedly prepares erroneous or fraudulent federal tax returns.

The IRS sent letters to all 19 individuals proposing revocation of their PTINs. Preparers facing revocation have 20 days to file a written response and provide supporting documentation as to why their PTIN should not be revoked. With the end of the tax filing season, the IRS also will initiate a review of tax returns that were prepared by a preparer who used an identifying number other than a PTIN, did not use any identifying number, or did not sign tax returns they prepared. The agency will send notices to those preparers who used improper identifying numbers. The IRS is also piloting methods to help identify returns that appear to be professionally prepared but are unsigned by the preparer.

"Hundreds of thousands of tax return preparers, the vast majority, play by the rules every filing season. The IRS is committed to ensuring they have a level playing field," Shulman said. "Compliance with regulations that require the signing of a tax return by a paid preparer and use of the PTIN is central to our enforcement effort."

The IRS is still registering approximately 2,000 preparers a week. Anyone who prepares for compensation all or substantially all of any federal return or claim for refund must register for a PTIN and pay a $64.25 annual fee. The PTIN registration is the first step in a multi-year effort by the IRS to provide standards for and oversight of the tax preparation industry. Starting this fall, certain paid preparers will be required to pass a new competency test. The IRS will also conduct background checks on certain paid preparers. Additionally, expected to start in 2012, certain paid preparers must have 15 hours of continuing education annually.

Certified public accountants, attorneys and enrolled agents are exempt from the competency testing and continuing education requirements because of similar professional standards already applicable to those groups. Supervised employees of these exempt groups also are generally exempt.

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.

RISK CORNER

Dodd-Frank and the Regulation of Over-the-Counter Derivatives

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is bringing greater regulation to the $600 trillion over-the-counter (OTC) derivatives market.

Among other things, Title VII of Dodd-Frank gives jurisdiction to the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) over swaps and some derivatives and imposes limits on federal assistance of swap entities. It also requires central clearing and trade reporting for standardized OTC derivatives.

I recently sat down to discuss the implications of Dodd-Frank on the derivatives market with Rhoda Woo, Ricardo Martinez, and Jeff Callender.

Woo is a managing director with Deloitte & Touche LLP in the Audit and Enterprise Risk Services Banking and Securities practice. She currently serves as the national security & privacy leader.

Martinez is a principal in Deloitte & Touche LLP's Enterprise Risk Services practice. He has more than 15 years of experience serving the financial services industry in the areas of credit and market risk management, derivatives processing, and fixed-income analytics.

Callender is a partner in Deloitte Tax LLP with more than 35 years of experience who specializes in coordinating the delivery of a broad range of tax services to his clients.

Q. What is the broad intent of Title VII of Dodd-Frank?

Woo: Title VII covers a lot of ground. First and foremost, it establishes the CFTC and SEC as the primary regulators for derivatives, and mandates that all swaps that are "clearable" – as defined by the two regulators – be cleared. In addition, Title VII includes the following provisions:

- Mandatory reporting requirements for both cleared and uncleared swaps;
- Capital and margin requirements, with higher requirements for uncleared swaps;
- Certain prohibitions on swap activities by insured depository institutions, a rule popularly called the Lincoln Amendment, named after its principal sponsor, former U.S. Sen. Blanche Lincoln (D-AR); and
- Greater public access to swaps transactions and pricing information.

Title VII also addresses several other issues, including portfolio margining, position limits, business conduct, and other matters.

The SEC and the CFTC have until July 16, 2011 to issue the final rules for derivatives.

Q. Who will be affected by the regulations?

Woo: We believe the heaviest burden will be on swaps dealers as well as the major swap participants. But end-users may also be affected, perhaps not from a regulatory point of view, but from an operational perspective, given the mandatory requirement of clearing swaps that are deemed to be clearable.

Title VII is also likely to spawn a number of changes in how different entities will decide whether they want to become Swap Execution Facilities (SEFs). What firms are going to want to take on more clearing business, what firms might want to get out of the business? So, we anticipate there will be a lot of business model impacts throughout the industry all around the derivatives marketplace.

The main takeaway is that the overriding goal of Title VII is to increase transparency as well as reduce the counterparty risk in the entire system.

Q. What are some of the key business implications of these provisions?

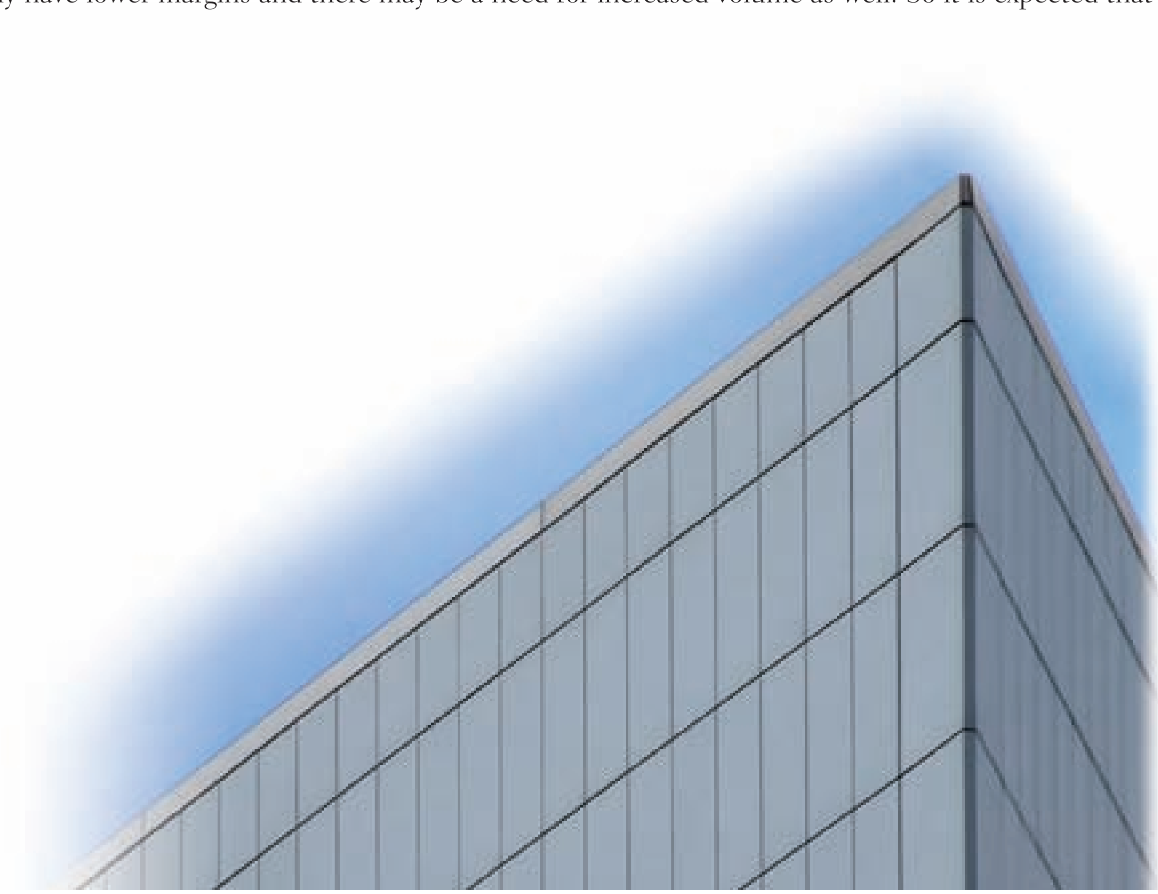
Martinez: The mindset in the OTC derivatives market has evolved from just understanding the regulation to making strategic business decisions, such as whether to expand into new markets or launch new services. It also involves tactical decisions, like choosing which vendors to use, which exchange to connect to, what Swap Execution Facility to execute with, and which industry utilities to use. That is just the beginning for a number of implications that cross operations, technology, risk management, compliance, and tax.

One result we have seen from all of this change is that senior executives are tending to take a more conservative approach to change and to their decisions. In the past, it was not unusual for projects to be initiated by silos in the institution and managed as such. I think this change is so big and so visible that people are taking more ownership and communicating more with peers across many different functions.

Q. How does Title VII affect participants in swap transactions?

Martinez: Swap Dealers and Major Swap Participants are legislatively required to change and make very visible business decisions. Major swap participants are those that have a substantial position or substantial counterparty exposure. They are also defined as those that are highly leveraged and will require additional amounts of capital.

One decision swap participants will have to make involves standardization and clearing. Standardized trades will likely have lower margins and there may be a need for increased volume as well. So it is expected that



a number of these trades, at least the outstanding ones, will be ineligible for central clearing. Participants will have to decide how big a position they want to hold and if it is worth the additional capital charges.

Q. What effect is Title VII expected to have on clearing swap transactions?

Martinez: Participants will need to decide whether they will clear transactions themselves or through another firm. This will likely have tangible operational effects, including how to connect to central counterparties.

Firms that will be considered Swap Dealers have to think of the provisional registration requirements and then complete the registration by September. In addition, they need to think about risk, margin, collateral, funding, and the technology that supports all of this.

Q. What are some of the key U.S. federal income tax considerations under Title VII?

Callender: I was talking recently with an industry executive who had a number of questions about Title VII, among them: Are these regulatory changes going to mandate different treatments for U.S. federal income tax purposes? Am I going to have to change? Am I going to be treated as being a different type of entity if I do this, that, or the other thing?

And the basic answer to these questions is "no," because the United States has its own set of tax rules that are not linked in lockstep to regulatory or other legal matters. However, there are tax implications because the regulatory regime now uses the term "swap dealer." We also have a concept of dealers in securities or dealers in derivatives in the Internal Revenue Code. I would expect anybody that is considered a dealer under the regulatory framework is probably a dealer for tax purposes.

The issue can get more complicated because a dealer can also do all of the three activities – invest, trade, or hedge. So the question is, how are those activities treated and into which bucket does this derivative activity fall?

If you are a major swap participant, then all bets are off. You can be any one of the things – you can be a dealer, investor, trader, or hedger – and all of the rules would be different.

Q. What specific tax implications might affect participants in derivatives transactions?

Callender: Perhaps the easiest way to understand the U.S. federal income tax implications of Title VII is to envision three high-level examples:

- An entity that has derivatives activity now and might be required to push it out;
- An entity receiving the derivatives activity; and
- The impact on counterparties when dealers or banks have to push out derivatives.

In the first example, dealers are going to be dealers, but major swap participants can fall into any of these categories. Dealers, in general, mark derivatives to market for tax purposes. If they need to push out the derivatives activity, there won't be any further taxable event because they are already marking to market.

However, if dealers are investors or traders and they have not made a mark-to-market election, or if they are hedgers and use different rules, then there very well could be a taxable gain or loss to take into account at the entity level.

In the second example, a taxable transaction for the entity receiving the derivatives would be the same as for the entities pushing out. So, the entity receiving the activity is going to have to determine its tax classification. It can be a dealer, investor, trader, hedger, and so the entity needs to determine what that entity and the activities are going to be and then decide if it is going to be a mark-to-market entity or not. In addition, depending on where the entity receiving the derivatives is located, certain foreign tax rules could come into play.

In the third example, there are actually two rules in the tax code that would force, if the bank is forced to push out the derivatives activity, the counterparty that is just sitting there, and possibly agreeing to accept the different counterparty, will likely have a taxable event.

This does need to be taken into account if you are on the buy side. If you are one of the parties who entered into a derivative with the bank and you are agreeing to let the bank push out, recognize that you might have to analyze whether you have a taxable event or not, even if you are not doing anything except agreeing to the transfer of counterparty.

So, that could be a significant issue, and if you are not marked-to-market, that could come as a little bit of a surprise to you. So, be forewarned.

Q. What business opportunities are being created by the changes in the regulation of OTC derivatives?

Martinez: Regulation is effectively mandating this change and we all know that change produces opportunities and part of this change includes the use of central counterparties (CCPs), regional clearing houses for derivatives transactions. Some central clearing facilities are beginning to take advantage of this to position themselves and perhaps either expand the asset classes they cover and/or enter new industries.

There already are a number of established participants as CCPs, but we see a potential for additional entrants. It is slightly different in the swap data repository (SDR) space, which is likely to be captured by the market utilities because they already have the connectivity and access to the data. I think that it is possible that a reduced number of SDRs may be a better scenario than a large number of overlapping firms.

In terms of market connectivity, the technology to connect all these different industry participants will be important, and there are a few firms that already have some of those capabilities, so it would be a natural extension into that existing framework. But opportunities for dealers, custodians, and other firms exist as well in such areas as client-clearing.

Overall, the early movers will have an advantage, but they are also working in a more volatile environment. I attended a clearing conference recently and one of the comments that was made was that in terms of connectivity to central clearing, CCPs should be in testing stages already. At some point, central clearing will become very crowded and you may not get enough attention to complete connectivity tests down the road. So, early movers will have an advantage on that front.

Q. With rulemaking still uncertain, what, if anything, can companies do now?

Martinez: First and foremost, to initiate change it is important to consider the governance models for mobilizing resources.

- The first is a centralized model, where a program management structure is put in place with the target and the clear mandate to adhere to and monitor all of the rules and efforts that are in place.
- The second is a siloed model, where each rule or set of rules has its own governance structure. There needs to be some connection among the individual governance structures, but that connection can be loose occasionally. Sometimes there is a conscious decision to create this structure, other times it just grows organically. So people started reacting to different rules in different ways and the models just evolved into these kinds of siloed efforts.
- The last is a reactive model, which is another way of saying there's no governance in place. So those are the firms that are trying to respond to those rules in an uncoordinated manner. We have seen a few of those where there may be overlapping efforts trying to respond to the rules.

Firms can start by identifying their internal capabilities and external dependencies, having the right governance structure in place, and determining the first areas to address before thinking about any implementation. This can be as simple as creating a matrix and mapping distinct activities map to each rule.

Q. What are the possible tax consequences of the Lincoln Amendment's "push-out" rule to companies that are subject to it as well as to companies that use derivatives to hedge commodity prices?

Mourtil: The push-out provision will require some banks to separate the swap dealer activity into a separate capitalized entity. Companies may need to restructure their operations as a result of this push out provision.

For domestic companies, choice of entity may not be a significant issue. However, foreign companies will need to think about the type of entity to choose and whether they would like to achieve consolidation with the foreign company. Those companies seeking consolidation are often trying to achieve an efficient structure that would allow income of one entity to be offset with losses of the other. Foreign companies that are considering transferring their derivatives offshore need to address whether those derivatives remain effectively connected to the U.S. trade or business while companies that are considering organizing new companies offshore need to determine whether such offshore entities will be considered to be engaged in a U.S. trade or business. In addition, existing swap dealers who will be required to push out their derivatives will need to determine the impact of such push out on their own hedging activities.

Callender: If you are in the hedging environment, and you made all the proper tax elections and identifications, pushing out swaps will have little-to-no effect on you because the tax rules say that if there is a taxable event in the hedge, you capitalize and amortize it as if it had never happened. So you just amortize it back into taxable income.

However, if the same thing were to happen to a hedge fund, the push-out may or may not create a taxable event.

Q. Looking ahead, what are people saying about the future of the derivatives market?

Woo: There seems to be a lot of debate over how rules will apply to non-financial end-users. Recent guidance suggest that regulators intend to read the spirit of Dodd-Frank, meaning that there would be exceptions for end-users.

We have already started to see some of the swap execution facilities starting to say, well, we know that we are supposed to say that we can self-regulate and self-audit by October 2011, but it's not clear whether we are going to be able to do that. So I think there is a lot of unknown about what are the deadlines going to be like. Will the regulators meet the targets? Who is going to be subject to a lot of the regulation?

When the rules become final and the spigot is turned on, what part of this marketplace is actually going to be centrally cleared? And will that be a measure of actual transparency in the market? That is a fascinating question.

Q. Is it likely that derivatives pricing will change?

Woo: Theoretically, everyone thinks that increased transparency should give you lower prices or should give you reduced margins and reduce spreads. Will that actually be the case?

With the higher cost of compliance and operations, and additional capital requirements, are dealers going to pass those costs on to commercial users? And who actually has the economic need for these hedges?

I think those questions speak to the sense of the debate. Will it make the derivatives actually more expensive? Is this going to cause a lot of the marketplace to flee to other places around the globe? Only time will tell.

Q. What role will the Federal Reserve have with derivatives?

Woo: The Federal Reserve (the Fed) has stated its commitment to work with the CFTC and the SEC together in reviewing the new rules. The Fed is also committed to coordinating with the international bodies, such as the Group of 20, the Basel Committee, and the Committee on Payment and Settlement Systems.

There needs to be consistency internationally, including how the regulation and supervision is approached for these products, and to help ensure that there is a level playing field when it comes to promoting stability and competition in this marketplace.

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

The Importance of Pictures...

In this issue of the *FORUM*, we are pleased to share with you several pictures taken at this year's 2011 National Risk Management Conference in Atlanta. These photos and Jennifer's great accompanying article help to capture the events, camaraderie, and impact of our national gathering. As I look at the pictures, I am "awe-struck" by their importance. Pictures give permanence to events.

The importance lies in the simple truth of photos. Pictures help tell the story. People appreciate pictures; we warm to them.They are fun. Pictures most certainly enhance connection. And, universally, we experience an added thrill of anticipation whenever pictures are about to be produced. So…the simple truth is that pictures are almost irresistible.

And, with regard to *FIRMA* publications, we will continue to offer photos that add value and connection. As always, please feel free to share your thoughts about FIRMA photos on our website or our Facebook, LinkedIn, or Twitter pages.

Lastly, I think there is another important impact of pictures – their influence in embracing history. FIRMA has just celebrated twenty-five-plus years of growth and influence. As our members and leaders look forward strategically, our future initiatives should be and will be developed upon our core principles – expertise, education, networking, member value, and industry influence. Pictures offer a reminder of these principles and values in action. They remind us always of what and who are important.

Sincerely yours,