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This complimentary newsletter addresses current regulatory concerns around the world and provides broker-dealers, investment advisers, and insurance companies with tips and suggestions for meeting regulatory obligations.



United States

Many RIAs Face March 31, 2011 Deadline for Updating Form ADV Part 2

The SEC amended Form ADV Part 2 and Registered Investment Advisers (RIAs) must submit their amendments in 2011. The changes include a “plain English” requirement and a new individualized “brochure supplement” (Part 2B) that will be required for thousands of RIAs. SEC-regulated advisers must file the new brochure no later than 90 days after their fiscal year end which makes the deadline for many firms March 31, 2011. Delivery of the brochure is required within 120 days after the fiscal year end. Most state-regulated advisers will also have to file the new brochure, but the deadlines vary from state to state.

Overview

Form ADV Part 2 is the disclosure document used by Registered Investment Advisory firms to describe the products and services offered to customers, as well as to provide location and contact information, conflicts of interest, compensation, fees, disciplinary actions, and other pertinent information. The Form has changed dramatically with regards to the presentation of the information, primarily to make the brochure easier to understand.

Part 2 now consists of three sections that are required to be delivered to the customer. Part 2A, otherwise known as the Firm Brochure, is the main document used to outline the disclosure information about the RIA. It contains a series of 19 items, each of which must be addressed using narrative responses. Appendix 1 of Part 2A is required when a firm sponsors a wrap fee program. Part 2B, the brochure supplement, contains information about the customer’s RIA and other supervised personnel.

The 19 items in Part 2A are designed to promote effective communication between the firm and the customer. The brochure and supplements should be written in plain English, taking into consideration the customer’s level of financial sophistication. The brochure should be concise and direct. The SEC’s Office of Investor Education and Advocacy has published *A Plain English Handbook* that can be found on the SEC’s website at www.sec.gov/pdf/handbook.pdf or by calling 1-800-732-0330.

LIMRA SPOTLIGHT

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January 11, 2011

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NOTABLE

► Cost-effectively meet the NAIC's Suitability in Annuity Transactions Model Regulation.

LIMRA's new Annuity XT training program and Compliance Suitability Survey can help you (1) ensure that producers complete basic suitability, plus your product-specific annuity training, before recommending an annuity product; (2) monitor sales; and (3) share findings with distribution partners. For more information or to see a demo of the new AnnuityXT training system, please contact Meggan Tufveson at 860-285-7859 or usclientservices@limra.com.

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When preparing the disclosures the SEC recommendation is to: (i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless you explain them or you believe that your customers will understand them; and (vi) avoid multiple negatives.

All information in the brochure and brochure supplements must be true and may not omit any material facts. However, the list of items in the brochure does not cover every possible disclosure, it is only a guideline. It is important that the author(s) take into account any additional information that may be relevant when developing the brochure. Under federal and state law, the RIA is a fiduciary and must make full disclosure to its customers of all material facts relating to the advisory relationship. As a fiduciary, the RIA must seek to avoid conflicts of interest with its customers; and, at a minimum, make full disclosure of all material conflicts of interest between the RIA and its customers that could affect the advisory relationship. These additional disclosures may be included in the brochure or provided via a separate document, but must be disclosed.

Each RIA must file the brochure(s) (and amendments) through the IARD system using the text-searchable Adobe Portable Document Format (pdf). (See SEC rules 203-1 and 204-1 and similar state rules.) If the RIA is registered or is registering with the SEC, they are not required to file the brochure supplements through the IARD or otherwise. They must, however, preserve a copy of the supplements and make them available to SEC staff upon request. (See SEC rule 204-2(a)(14).) If the RIA is registered or is registering with one or more state securities authorities, they must file a copy of the brochure supplement through the IARD for each supervised person doing business in that state.

ADV Part 2A (Firm Brochure)

The firm brochure format has 19 sections/items that require completion. While the format has changed dramatically, the content of the disclosure(s) represent much of the same subject matter required previously. The sections, in the required order are:

1. Cover page
2. Material changes
3. Table of Contents
4. Advisory Business
5. Fees and Compensation
6. Performance-Based Fees and Side-by-Side Management
7. Types of Clients
8. Methods of Analysis, Investment Strategies and Risk of Loss
9. Disciplinary Information (RIA and Management/Control Persons)
10. Other Financial Industry Activities and Affiliations
11. Code of Ethics, Participation or Interest in Client Transactions and Personal Trading

12. Brokerage Practices
13. Review of Accounts
14. Client Referrals and Other Compensation
15. Custody
16. Investment Discretion
17. Voting Client Securities
18. Financial Information
19. Requirements for State-Registered Advisers

Detailed instructions for completing each section of the Part 2A may be found on the NASAA website at: <http://www.nasaa.org/content/Files/Form-ADV-Part-2-Instructions.pdf>.

Part 2A Appendix 1 (Wrap Fee Program Brochure)

If the RIA sponsors a wrap fee program, then a wrap fee program brochure must be delivered to wrap fee customers. The disclosure requirements for preparing a wrap fee program brochure appear in Part 2A, Appendix 1 of Form ADV. If the entire advisory business is sponsoring wrap fee programs, there is no need to prepare a firm brochure separate from the wrap fee program brochure(s). (See SEC rule 204-3(d) and similar state rules.) However, if a wrap fee program has multiple sponsors and another sponsor creates and delivers to wrap fee program clients a wrap fee program brochure that includes all the information required, an additional separate wrap fee program brochure does not have to be prepared and delivered for each additional sponsor.

A wrap fee program brochure takes the place of the advisory firm brochure required by Part 2A of Form ADV, but only for clients of wrap fee programs that the RIA sponsors. (See SEC rule 204-3(d) and similar state rules.)

Part 2B (Brochure Supplement)

The brochure supplement is the section that is creating the most questions and is new to the ADV. The brochure supplement provides a detailed profile of the supervised advisory individual, including information about the educational background, business experience, and any disciplinary history. The brochure supplement must also be presented in narrative format and use plain English to communicate with the customer.

The brochure supplement is broken down into seven items:

1. Cover Page
2. Educational Background and Business Experience
3. Disciplinary Information
4. Other Business Activities

5. Additional Compensation
6. Supervision
7. Requirements for State-Registered Advisers

A brochure supplement must be prepared for the following supervised persons: (i) Any supervised person who formulates investment advice for a customer and has direct customer contact; and (ii) Any supervised person who has discretionary authority over a customer's assets, even if the supervised person has no direct customer contact. (See SEC rule 204-3(b)(2) and similar state rules.)

Not all supervised persons are required to have a brochure supplement. A supervised person who has no direct customer contact, and has discretionary authority over a customer's assets only as part of a team, does not need a supplement. In addition, if discretionary advice is provided by a team comprised of more than five supervised persons, brochure supplements need only be provided for the five supervised persons with the most significant responsibility for the day-to-day discretionary advice provided to the customer. (See SEC rule 204-3(b) and similar state rules.)

Emphasis is being placed on the RIA's requirement to provide accurate information. The Disciplinary Information (Item 3) presents some potential challenges for the RIA. The use of the FINRA BrokerCheck system (www.finra.org/brokercheck) and the IAPD system (www.adviserinfo.sec.gov) provides a good starting point. However, RIAs should consider using a third-party background check service in addition to a thorough questionnaire to ensure that the Investment Adviser Representative's information is accurate and contains the required level of disclosure.

Smaller firms may want to consider providing the brochure supplement information within the RIA brochure as supplemental information, especially if there are limited supervised advisory personnel. Larger firms will need to evaluate the amount of resources available to complete the requirements of the new ADV format.

Additional guidance may be found on the IARD website, including a navigation guide and FAQs by following the link: <http://www.iard.com/part2instructions.asp>. ADV Part 2 Versions in both Microsoft Word and Adobe PDF may be found at http://www.nasaa.org/industry_regulatory_resources/investment_advisers/758.cfm.

By John Taylor-Jones and Victor A. Shier, LIMRA Regulatory Services Consultants. LIMRA's Compliance and Regulatory Services offers assistance with background verification and updating ADV Part 2.

An Emerging Trend: Increased Producer Compensation Transparency

This is the first in a series of articles on Compensation Transparency inside various models: insurance producer, retail BD, IA, and a potential fiduciary standard.

NY Reg. 194 was the direct result of the state insurance department's reaction, along with the Office of Attorney General, to the settlement agreements reached in 2005 with several large national insurance brokers. As part of the settlement of the cases which alleged unlawful steering of insurance policies based upon fraudulent quotes, the brokers agreed to heightened transparency in all future dealings. The new regulation is similar to the steps agreed to be taken by the defendants. Industry groups and broker groups have protested this rule as an overreaction, saying that it is not based on any real customer harm, and that the 100,000 individual NY insurance producers are rarely involved in the type of transactions that were at issue in the 2005 cases. Despite the challenges, the new regulation marches steadily toward its effective date of January 1, 2011. On November 5, 2010, the New York Insurance Department published [Circular Letter #18](#).¹

CL 18 is helpful to the many firms that were grappling with how to implement this regulation that requires producers to disclose generally that they are compensated on the products sold, and specifically if requested, what that compensation involves. The difficulties arise not so much from how to disclose the commissions and other premium-based compensation, but rather the myriad other contingent compensation elements and benefits derived from the sale or aggregated sales, some of which are known, and some unknown, at the point of sale.

Reg. 194 allows for "reasonable estimates" of contingent compensation to be given, and CL 18 explains some examples of how those might look. The regulation's intent is to introduce transparency into the transaction that allows the consumer to understand what, if any, incentive might exist for the producer to sell one product over another. The regulation requires the producer to, at point of sale, explain orally or in writing:

- their role and who is compensating them,
- either the insurer or some other third party,
- based on the sale of the product they are recommending,
- whether their compensation varies based on sales volume, the contract they select, overall profitability or other factors.

Further, the producer must explain that the consumer can request more information about the amount and any alternatives the producer presented. No particular format is required for the disclosures mandated by §30.3(a). Producers may satisfy the initial disclosure requirement with a "boilerplate" form to use for each written disclosure. An initial disclosure may be, but is not required to be, a statement a few sentences long.

Should consumers opt to obtain the added information, producers have five business days — ideally prior to issue of the insurance — to provide:

1. A description of the nature, amount, and source of any compensation to be received by the producer or any parent, subsidiary, or affiliate based in whole or in part on the sale;
2. A description of any alternative quotes presented by the producer, including the coverage, premium, and compensation that the insurance producer or any parent, subsidiary, or affiliate would have received based in whole or in part on the sale of any such alternative coverage;
3. A description of any material ownership interest the insurance producer or any parent, subsidiary, or affiliate has in the insurer issuing the insurance contract or any parent, subsidiary, or affiliate;
4. A description of any material ownership interest the insurer issuing the insurance contract or any parent, subsidiary, or affiliate has in the insurance producer or any parent, subsidiary or affiliate; and
5. A statement whether the insurance producer is prohibited by law from altering the amount of compensation received from the insurer based in whole or in part on the sale.

While most producers are clear on their role in these transactions and who is paying them, they may find it difficult to draft a clear disclosure of the other elements on their own. They could reasonably expect some assistance from the insurer paying their compensation, specifically on how to reflect certain contingent or future elements of their compensation accurately. CL 18 clarifies this somewhat, saying that producers are "not required to disclose detailed compensation structures but must provide a description of the circumstances that may determine the receipt and amount or value of any compensation not known at the time of disclosure. For example: 'I may also be eligible for additional compensation depending upon a number of factors including premium and policy volume, losses and profitability.'"

CL 18 also provides some much-needed guidance on how to describe the amount of the compensation. Producers can accomplish this disclosure by giving a dollar range or percentage of the premium that would be paid over the expected life of a typical policy. They can only do this provided that range or amount is accurate and based on the actual experience of the producer or the issuing firm, and provided it includes a statement that most compensation is paid in the first year if such is the case, or that most of the compensation is paid in the first 5 years if such is the case. Example: “I expect to receive from the insurer 8% of the total premium you pay on this policy if you keep the policy in place for 13 years which is the expected average duration of this type of policy. Most of that compensation will be paid in the first year.”

Most firms will provide a template to producers who are impacted by the regulations helping them to describe the parent company’s ownership of the producer or what the effect might be of the producer’s ownership of the insurer such as being a common stockholder of the insurer. Templates should include information for producers to accurately reflect the prohibitions of the anti rebating statutes, or that insurance companies don’t individually negotiate the terms of producer contracts. Producers should also disclose, where applicable, their inability to alter the amount of compensation from the transaction.

More complex compensation elements, often contingent upon some future occurrence such as meeting sales volume, profitability or retention targets, are often unknown at point-of-sale but still need to be disclosed. Some of these may present descriptive challenges. Examples of these compensation elements are listed below

- Forgiven loans
- Marketing expense reimbursements
- Staff expense reimbursements
- Benefit contributions
- Office supplies and furniture
- Advertising
- Telephone and computer hardware or software
- Conference attendance
- Incentive bonus compensation
- Deferred compensation arrangements
- Stock grants

CL 18 provides some help here in that it permits producers to describe generally their overall yearly compensation provided it is a “reasonable estimate” of such compensation in a dollar amount or expressed as a percentage of premium or annual compensation,

and may be described as contingent by saying, “I may also be eligible for additional compensation depending on a number of factors including premium and policy volume, losses, and profitability.” The amount of such compensation disclosed can be expressed as a range of dollar amounts, or an estimate provided by the insurer based on averages paid to producers in similar circumstances. Or, it could be disclosed as a percentage of premiums using the amounts paid to the producer in prior years on similar policies.

Despite the challenges, the NY department does expect full compliance with the regulation beginning January 1, 2011. However they allow that for the first six month their enforcement efforts will focus only on “egregious or willful violations,” or those “demonstrating a pattern or practice of wrongdoing.”

By Larry Niland, Senior Regulatory Consultant, LIMRA, and former CCO of the John Hancock Financial Network. Please contact Larry at 877-843-2641 or lniland@limra.com if you have any questions about this article.

Transaction Recommendations in Social Media

There is a sumptuous variety about the New England weather that compels the stranger’s admiration — and regret. The weather is always doing something there; always attending strictly to business; always getting up new designs and trying them on the people to see how they will go. But it gets through more business in spring than in any other season.²

— Mark Twain

Social media is going through its own New England spring. There are always new designs, much to admire, and the potential for much regret. Social media companies are continuously trying new designs on the public to see which fit, and to see how the public will go. Forecasting the direction of social media development is a little like weather forecasting — of dubious accuracy and the source of much frustration. While forecasting weather is difficult, recognizing a change in season is easier. If social media is going through its own spring, the maturation of strategy and tactics, i.e., the summer of social media, naturally follows. These tactics will include making product recommendations through social platforms. Such recommendations are governed by existing suitability regulations and advertising laws. This article focuses on one of the most basic rules of making suitable recommendations — “know your customer.”

[FINRA Regulatory Notice \(RN\) 10-06](#)³ provides an overview of a firm’s responsibilities when allowing the use of social media. RN 10-06 largely tells us that existing rules and regulatory guidance apply to social media. Answer 2 or “A2” in the “Questions and Answers” section of RN 10-06, refers to [NASD Notice to Member \(NTM\) 01-23](#) “Online Suitability — Suitability Rule and Online Communications.”⁴ “Social media” did not exist as we know it today when NTM 01-23 was written. However, it is clear that NTM 01-23 applies to today’s social media sites. FINRA (NASD at the time) wrote the following:

NASD Regulation generally would view the following communications as falling within the definition of “recommendation”:

The NASD provides three examples before including:

A member uses data-mining technology (the electronic collection of information on Web Site users) to analyze a customer’s financial or online activity — whether or not known by the customer — and then, based on these observations, sends (or “pushes”) specific investment suggestions that the customer purchase or sell a security.

This language was written in 2001 when cookies were a primary method of capturing customers’ use of websites. The language was written broadly to include many different technologies. Based on the plain language of NTM 01-23, it appears that the strength of building relationships on the social net, and using information to promote products will in fact bring [FINRA Rule 2310](#)⁵ to bear on such communications. Note that the term “data-mining” is used broadly in NTM 01-23, and that by referencing NTM 01-23, the authors of FINRA Regulatory Notice 10-06, apparently intended to apply the definition of data mining to social networks.

Before analyzing exactly how data mining occurs, it is important to understand that the three major social media sites — Facebook, LinkedIn, and Twitter — are three very different networks and present different kinds of data. Facebook is a true social network wherein the primary relationships and communications focus on personal relationships and life events. LinkedIn belongs to a subset of social networks properly called business networks, wherein the primary relationships and communication focus on professional relationships and business events. What Facebook and LinkedIn have in common is a direct one-to-one relationship between friends (Facebook) and connections (LinkedIn). Both parties mutually agree to let one another into their networks.

Twitter, however, is an information network. Twitter relationships are categorically different than those on Facebook and LinkedIn because Twitter does not demand

a one-to-one relationship. Twitter relationships are better expressed as “x” to “n”; where “x” is the number of people I choose to follow, and where “n” is the number of people who choose to follow me. “X” is limited by my choices of whom I will follow. “N” is theoretically limited by two primary factors: 1) the number of people in the Twitter network; and 2) whether or not I choose to limit the number of followers who can subscribe to my Tweets. I can limit the number of followers by blocking certain followers (generally open subscription — except for those blocked) or by limiting followers only to those I approve (generally closed subscription — except for those people I invite into my network).

Bearing in mind the differences in relationship types, this analysis will focus on Facebook to illustrate the potential for data mining contemplated under NASD NTM 01-23. The following information is available through Facebook’s pressroom.⁶

- Average user has 130 friends
- Average user is connected to 80 community pages, groups, and events
- 50% of active users log on to Facebook in any given day
- Average user creates 90 pieces of content each month
- More than 30 billion pieces of content (web links, news stories, blog posts, notes, photo albums, etc.) are shared each month

Assume that a salesperson fits the definition of an “average user.” That salesperson — with 130 friends — will see each of those 130 friends generate 90 pieces of content each month, or $130 \times 90 = 11,700$ pieces of content. Much of that content may be junk for marketing purposes. For example, can a salesperson extract any useful information about a prospect by analyzing “rainbow chicken”⁷ activity on Farmville? However, useful data is presented in those 11,700 pieces of content, much of which communicates life events such as births, deaths, new jobs, and sickness. It is precisely those life events that can — and arguably should be — used to promote appropriate and suitable products and services. The question is: “When do such communications become recommendations?”

Scenario 1: Assume that a friend announces the birth of a couple’s first baby. That child has certain expenses, from living expenses through college tuition, which need to be covered should one or both parents die. Assume that the salesperson — a registered representative — has good reason to believe from past conversations that the friend with the newborn is a moderately aggressive investor. The salesperson decides to use the “Send Message” function within Facebook to congratulate the friend on the birth of the newborn, remind the friend of the child’s needs,

and tells the friend that variable universal life insurance (VUL) is a great way to meet the child's financial needs if a parent dies. The salesperson then offers to help the friend buy an Acme Insurance Company VUL contract. Clearly this is a recommendation.

Scenario 2: Assume the same fact pattern except the salesperson does not mention any specific kind of product or product type. Instead, the salesperson invites the friend with the newborn to meet to discuss financial planning concepts and current holdings. A life event has been communicated and this data has been "mined." The salesperson reaches out to a prospective client with an offer to meet about needs and current holdings. The implication is that something must be done. In reality, that "something" is most likely transactional, and probably entails a combination of both selling (i.e. surrendering) some financial products and buying others. Absent mention of a specific product or instrument, there is a strong argument that a recommendation has not in fact been made. However, key data regarding the needs of the prospect are present. If the discussion does in fact lead to a sale, firms should consider including a provision for capturing and retaining the need first expressed in the Facebook platform.

Social media compliance is complex because social media does not represent a single technology. It is complex because social media sites are an amalgam of technologies seamlessly integrated into a single platform. Using a key principle from RN 10-06 — that old rules apply to social media — the problem changes from one of complexity to one of detail. Social media compliance best practices will begin to emerge through detailed analysis of readily available regulatory guidance. By analyzing NTM 01-23 in the context of RN 10-06 we have seen that data-mining and the resultant client communications which might arise, can cause FINRA Rule 2310 to apply. If firms do permit the use of social media, they need to supervise their registered representatives activities on the social net.

This article has focused on the potential applications of FINRA Rule 2310 to recommendations made in the social net. Insurance companies are strongly encouraged to review FINRA RN 10-06, even if they are not subject to supervision by FINRA. The NAIC Suitability in Annuity Transactions Model Regulation⁸ appears to have drawn heavily from [FINRA Rule 2330](#) Members' Responsibilities Regarding Deferred Variable Annuities⁹ (formerly FINRA Rule 2821). If insurance regulators are reading FINRA Rules to use as guidance for constructing parallel insurance product regulations, it may be reasonable to assume that insurance regulators may also draw upon documents such as RN 10-06 and NTM 01-23 to shape

their own views on communications related to suitability and recommendations.

By Stephen Selby, Director of Regulatory Services, LIMRA. Please contact Stephen if you have any questions about social media compliance, at 860-285-7858 or sselby@limra.com. Connect with Stephen at <http://www.linkedin.com/in/stephenselby>.

Title 31 Chapter X — Financial Crimes Enforcement Network

"The Transfer and Reorganization of Bank Secrecy Act Regulations"

A New Home for Bank Secrecy Act Regulations

How we reference Bank Secrecy Act (BSA) regulations is about to change — for the better. Effective March 1, 2011 BSA regulations will transfer from Title 31, Code of Federal Regulations (CFR) Part 103 to a new Chapter "Title 31 Chapter X — Financial Crimes Enforcement Network." The objective is to make it easier to determine and comply with BSA regulatory requirements. This move of the regulations to Chapter X within Title 31 provides FinCEN with the opportunity to restructure its regulations so that they can readily be identified as being specific to a particular regulated industry or as being generally applicable to all regulated industries or covered persons. Making the regulatory obligations clearer in their structure and more readily accessible to regulated institutions facilitates compliance and thereby advances the purposes of the Bank Secrecy Act (BSA) to protect the financial system from criminal abuse. Individuals will be able to more easily identify which BSA rules are applicable to their financial institution by referencing two places within Chapter X. Those places are Part 1010 "General Provisions" relevant to more than one regulated industry or covered persons; and the Part specific to a particular regulated industry. For example, individuals interested in identifying BSA regulations applicable to insurance companies only need to reference Chapter X, Part 1010 "General Provisions" and Part 1025 "Rules for Insurance Companies."

How Did This Come About?

On November 7, 2008 FinCEN published a Notice of Proposed Rulemaking (NPRM) and request for comments in the *Federal Register*. (See *Federal Register*/Vol. 73, No. 217, Friday, November 7, 2008 Proposed Rules, p. 66,414.) In Section V of the NPRM, FinCEN invited comments on all aspects of the proposed restructuring of the regulations — specifically on whether the structure and numbering logic of the sections and parts within

Chapter X made the BSA regulations more accessible; and whether the alphabetical order and maintenance was clear, effective, and of such value that FinCEN should renumber the definitions at that time and each time a new definition was added. Written comments were to be submitted to FinCEN on or before March 9, 2009.

On October 26, 2010 FinCEN published the Final Rule to move the BSA regulations into a new chapter in the Code of Federal Regulations, 31 CFR Chapter X with an effective date of March 1, 2011. (See Federal Register/ Vol. 75, No. 206/Tuesday, October 26, 2010/Rules and Regulations, p. 65,806.)

Notable Features

Chapter X does not create new regulatory requirements or alter any existing regulations. Each part of Chapter X, including Part 1010 “General Provisions” and each of the industry-specific parts, contains similarly titled and ordered subparts. They are:

- Subpart A — Definitions
- Subpart B — Programs
- Subpart C — Reports Required To Be Made
- Subpart D — Records Required to Be Maintained
- Subpart E — Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activity
- Subpart F — Special Standards of Diligence; Prohibitions; and Special Measures.

This structure is designed to facilitate comparative analysis between the various parts of Chapter X. FinCEN’s updated forms reflecting 31 CFR Chapter X citations will be available for use as of March 1, 2011.

Transition Period Considerations

During the transition time, published documents will continue to contain citations to 31 CFR Part 103. Effective March 1, 2011 citations for FinCEN’s regulations will be to 31 CFR Chapter X. To assist this transition, FinCEN has created a Chapter X general cross-reference index. This can be accessed at http://www.fincen.gov/statutes_regs/ChapterX.

Practical Applications

- Individuals with AML responsibilities should familiarize themselves with 31 CFR Chapter X. Insurance company’s existing policies, procedures, compliance manuals, and training materials undoubtedly have references to 31 CFR Part 103 that will need to be updated effective March 1, 2011.
- Revisit independent testing plans to address the change of citations at the effective date.

- This transfer and reorganization of BSA regulations provides an opportunity to compare your AML Program to Chapter X requirements to verify that it meets all regulatory requirements and that all definitions appearing in Chapter X are consistent with your understanding.
- This is an excellent initiative by FinCEN. They provide comprehensive guidance on their website (<http://www.fincen.gov>) regarding Chapter X and provide contact information for asking questions about Chapter X.
- Start building your working knowledge of Chapter X now to make your AML Program’s transition to Chapter X seamless.

By Rob Goecks, MBA, CPA, CAMS, LIMRA Senior Regulatory Consultant. Goecks has 37 years of BSA/AML experience. Call 877-843-2641 to learn more about LIMRA’s AML Independent Testing and Dynamic Risk Assessments.

Make the Case for Litigation Preparedness in Your Electronic Record-Keeping Initiatives

Broker-dealers and investment advisers have led the charge with proactive electronic record-keeping initiatives — in many ways out of necessity. For more than a decade, preservation, supervision, and data protection obligations mandated by the SEC and FINRA have motivated firms to implement policy and adopt appropriate archiving solutions for governing the use of electronic communications.

Beyond regulatory compliance, this proactive approach to managing growing volumes of electronic communication is a legal necessity for virtually any company, especially those in highly-litigious fields. What seems simple — the knowledge of what electronic data you have, and the ability to locate and produce it quickly in its original form — is much more difficult in practice, but essential to litigation preparedness efforts. Unfortunately, many businesses come to this realization during or after a litigation event or e-discovery request, and are forced to weather the subsequent drain on resources, exorbitant legal costs, and potential sanctions.

E-discovery, the compulsory, pre-trial disclosure of pertinent electronically stored information (ESI) to the opposing party in a civil action, is standard practice and can get expensive very quickly. The American Records Management Association (ARMA) estimates that more than 90 percent of today’s business records are electronic, and e-discovery represents 35 percent of the total cost of litigation. Even if your company prevails in a lawsuit, it can still be sanctioned for irresponsible e-discovery practices.

ESI covers a broad spectrum of digital content — from email and other forms of electronic messaging to files, spreadsheets, and presentations — and may potentially extend to the devices that the data is stored on (such as desktop computers, laptops, smart phones, and backups).

At the heart of this voluminous mass is the business world's communications vehicle of choice: email. According to research from Enterprise Strategy Group, approximately 80 percent of electronic discovery events involve email and attachments. Email and electronic message archiving is a core component of a risk management strategy. As those with SEC or FINRA examination experience can attest, having a centralized email and electronic message repository with an archiving solution in place can dramatically increase the ability to produce what is requested efficiently.

The FRCP and E-Discovery

The primary body of rules governing court procedures for managing civil suits is the Federal Rules of Civil Procedure (FRCP) and state versions of the FRCP. These require that organizations must manage their ESI so that it can be produced in a timely and complete manner when necessary, such as during legal proceedings.

Formal court-ordered requests virtually always have deadlines. In addition, under Rule 26(f) of the FRCP (and its analogous state rules), parties involved in civil litigation must “meet and confer” with the opposing counsel early in the case to discuss the scope and timing of discovery, preservation efforts, the production of electronically stored information, and early case resolution. This session usually takes place within 60 to 90 days of a case being filed.

The sooner a participant has a clear understanding of what ESI it has and can access, the better served the party will be. Difficulty in accessing relevant ESI does not excuse parties from their obligation to produce data, nor from the cost and man-hours associated with collection and production. Reactive solutions to e-discovery, such as reliance on back-up tapes, can be extremely costly and may open companies to risks based on the timeliness of compliance and/or storage reliability.

Whether during a formal or informal early-case assessment process, a comprehensive survey of the data available within an email archive can help counsel get a better understanding of the timeline, storylines, involved individuals, and critical documents. Does the “smoking gun” exist in your email system? Companies may be able to get accurate context quicker — expediting the answer

to “defend or settle” and the path to the most logical business resolution, and limiting e-discovery and legal counsel costs.

Legal Hold, Retention, and Spoliation

Companies must be able to place a legal hold on documents identified as relevant to pending litigation, such as all communication to and from specific individuals. This classification exempts material from standard company disposition schedules. With a reasonable expectation of a lawsuit, failure to preserve this data leaves companies vulnerable to spoliation (destruction/material alteration of a document so as to render it invalid) sanctions for failure to preserve or produce the required electronic evidence.

Case law lends further insight on the cost and risk of spoliation of evidence. Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York wrote the landmark *Zubulake v. UBS* opinion six years ago, establishing the duty to preserve evidence and the concept of legal hold. In the 2010 decision *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities*, Judge Scheindlin argued that firms that fail to adequately retain information (such as documents or emails) could be subject to monetary sanctions and be held responsible for the prevailing party attorney's fees if they acted in a negligent manner. Specifically, she also found that companies with a duty to preserve data (which could exist well before a claim is brought) could be at risk if they allow employees to search their own documents to decide what is relevant, or if they delegated search efforts without any supervision from management.

Regulatory and statutory requirements, in many cases, dictate appropriate retention periods and disposition schedules for electronic data. The notion that destroying data in the absence of reasonable and enforced retention policies is a solution to potential litigation certainly leaves the door open to spoliation charges.

Metadata Matters

The days of filling file cabinets and boxes in storerooms with printed hard copies of business records are over. Beyond the logistical challenges created by the exponential proliferation of email and electronic messages — Osterman Research data indicates that the volume of messaging storage is growing at roughly 30 percent annually — case law suggests that the original, intact metadata, generated by forms of electronic communication, is critical.

Two recent state Supreme Court cases in Washington (*O'Neill v. City of Shoreline*) and Arizona (*Lake v. City of Phoenix*) both ruled that the metadata of electronic records are discoverable. This “data about data” refers to system-generated content (header, IP address, date, sender and recipient data, for instance), and plays a significant role in validating message integrity and chain of custody.

Go Proactive

Should a lawsuit emerge, a proactive approach to archiving electronic data will help companies streamline the e-discovery process, respond more effectively, implement effective legal holds, and reduce costs. With proactive monitoring of electronic communications for policy enforcement and risk, firms may be also able to identify and address potentially litigious situations and avoid legal action altogether.

Additional Resources/White Papers Available at Smarsh.com

- Enterprise Strategy Group, *Software-as-a-Service: An Ideal Email Archive Solution for Medium-Size Businesses*, by Brian Babineau, February 2009.
- Osterman Research, *The Concise Guide to E-Discovery*, January 2010.
- Osterman Research, *Convincing Decision Makers of the Critical Need for Archiving*, May 2010.
- Smarsh Inc., *Practical Applications: Reduce Litigation Costs Using Email Archiving for Early Case Assessment*, by Seth H. Row, August 2009.

By Ken Anderson, Senior Director of Communications, Smarsh.

Global

Riesgo Operacional [Operational Risk]

(A summary of this article in English begins on page 11.)

En los últimos años hemos observado un crecimiento progresivo de la preocupación de las entidades financieras por el riesgo operacional.

Se trata de un riesgo que, aunque siempre ha existido en el mercado financiero, quizás ahora se manifiesta con mayor intensidad, debido a factores tales como las mejoras tecnológicas y la creciente complejidad y globalización del sistema financiero. Como respuesta a este fenómeno, los acuerdos de Basilea II, que buscan potenciar la estabilidad de los mercados financieros mediante la adecuada capitalización de las entidades, manteniendo un capital mínimo equivalente al porcentaje de los riesgos asumidos, ha repercutido en las distintas entidades que han debido incrementar paulatinamente los recursos asignados a minimizar los riesgos operacionales, pasando de la simple mejora de los sistemas de control, al desarrollo de modelos de medición y gestión del riesgo operacional, que intentan obtener una estimación razonable del impacto de futuras pérdidas.

Asimismo, a partir del concepto de Gobierno Corporativo que hace algunas décadas fue identificado en los países más desarrollados del oeste de Europa, en Canadá, los Estados Unidos y Australia, como “un conjunto de prácticas corporativas por el cual las Compañías

son dirigidas y controladas para la creación de valor, integrando los intereses de los Controladores, Directorio, Alta Dirección y los distintos grupos de interés que interactúan dentro y fuera de una organización” nacen una serie de iniciativas preventivas en relación con delitos de Compliance. Por lo anterior, en Chile desde hace años las instancias relacionadas con el Gobierno.

Corporativo de las organizaciones incluidas las Compañías de Seguros de Vida y Generales, han tomado relevancia y se han transformado en un tema recurrente de debate público, en relación con los mecanismos institucionales necesarios para el proceso de dirección y toma de decisiones.

Junto con lo anterior, se ha sumado el consenso en la necesidad de combatir los delitos de Lavado de Activos, financiamiento de terrorismo y el cohecho, materias éstas, que, con el apoyo de las instituciones internacionales y nacionales, privadas y públicas se ha podido avanzar como país.

También ha sido pilar fundamental, la voluntad decidida de los Directorios de instruir desarrollar, políticas, códigos de éticas y de funcionamiento como marco de acción para todos los integrantes y colaboradores de las organizaciones. Se ha podido conformar un marco de acción común normativo y de alcance que deben tener como objetivo lograr garantizar la capacidad de identificar y de medir los riesgos que asuma la institución y que los

modelos utilizados incorporen el enfoque estratégico del negocio, permitiendo robustecer aún más la confianza del mercado respecto de todos los actores participantes. Sin embargo, desde la perspectiva del combate del fraude que también forma parte del Compliance de las organizaciones, cada día más las empresas destinan recursos y esfuerzos crecientes con la finalidad de perfeccionar los niveles de mitigación de las ocurrencias de fraude en la organización vía una serie de distintos mecanismos entre ellos, sistémicos, de verificación etc.

En lo referente a las Compañías de Seguros de Vida, los productos asociados al ahorro son quizás los más vulnerables en materia de lavado de activos, en el sentido de deber conocer con exactitud el origen de los fondos. Nuestro país cuenta con instituciones como la Unidad de Análisis Financiero, que tiene como misión prevenir el lavado de activos y el financiamiento del terrorismo en Chile, mediante la realización de inteligencia financiera, la emisión de normativa, la fiscalización de su cumplimiento y la difusión de información de carácter público, protegiendo al país y a su economía de las distorsiones que generan ambos delitos. Y la Superintendencia de Valores y Seguros, que debe resguardar los derechos de los inversionistas y asegurados para propender al desarrollo de los mercados de valores y seguros a través de una regulación y una fiscalización que facilite el funcionamiento de éstos, de manera confiable y transparente, entre otras entidades que finalmente velan por el fiel cumplimiento de las leyes y normativas vigentes, para entregar solidez y cumplimiento al sistema de resguardo existente. Finalmente, estamos conscientes de la necesidad de seguir avanzando en el control de estos temas. La sofisticación de los defraudadores actuales, hace la tarea más difícil y es necesario implementar un modelo de gestión de riesgos que permita visualizar las vulnerabilidades e identificar los riesgos con el objeto de definir planes de acción conducentes a limitar la ocurrencia de este tipo de hechos delictuales.

By Enrique Margotta Saavedra, Gerente Contralor de Compañía de Seguros CorpVida S.A. y Compañía de Seguros CorpSeguros S.A., es Contador Auditor de la Universidad Tecnológica Metropolitana de Chile.

Operational Risk

In the past few years financial institutions have become progressively more concerned about operational risk. Although this risk has always existed in financial services, it has intensified due to improved technology and the complexity and globalization of financial systems.

In response to this concern, the Chilean government implemented Basel II — designed to improve the stability of the financial markets by supporting the entities that have assumed risks, and by gradually increasing the resources used to minimizing risk. This is done by improving systems control, managing operational risk, and obtaining a reasonable estimation of the impact of future losses.

More developed countries — such as Western Europe, Canada, the United States, and Australia — have corporate governance practices that create value and integrate the interest of the companies. Controllers, Boards of Directors, and special committees from inside and outside an organization work to develop a series of preventive initiatives regarding compliance crimes.

In the past few years, Chilean corporations — including life and general insurance companies, with the help and support of international and national private institutions, have taken steps to process and make decisions about the prevention of money laundering and/or the financing of terrorism. This has allowed Chile to advance as a country.

The *CorpVida Insurance* Board of Directors has developed a fundamental policy, code of ethics, and a plan of action for all of its members. They agreed on a plan of action to identify and measure the risk that the institutions assume, while also allowing the models used to incorporate the strategic approaches of the businesses and to address concerns, allowing for more confidence in the company. In order to combat fraud, compliance organizations have designated resources and increased efforts to identify fraud in the organization, through a series of systematic checks.

What concerns Vida's insurance company, are the products that are vulnerable to money laundering. They must accurately identify the source of the funds. Our country relies on its financial institutions to analyze, anticipate, and prepare for money laundering, in order to reduce the financing of terrorism in Chile. This is accomplished by issuing regulations regarding public information, protecting the rights of investors and policyholders, and developing systems to execute those laws and regulations.

Finally, we are aware of the need to continue to take control in managing risk. The sophistication of defrauders makes the task more difficult; and, it is necessary to identify where our companies are vulnerable, to continue to identify the risks in order to define action plans that will limit the occurrences of fraud.

Original article written by Enrique Margotta Saavedra, Manager Controller of CorpVida Insurance Company & Insurance Company CorpSeguros, and Auditor of the Technological Metropolitan University of Chile.

Article summarized in English by Melissa Ocasio-Willbrant, Compliance and Regulatory Services, LIMRA.

¹[http://www.midhudsonaifas.citymax.com/f/NYSID_Circular_Letter_No._18_\(Reg_194_Final_11-5-2010\).pdf](http://www.midhudsonaifas.citymax.com/f/NYSID_Circular_Letter_No._18_(Reg_194_Final_11-5-2010).pdf)

²<http://www.islandnet.com/~see/weather/arts/twain1.htm>

³<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120779.pdf>

⁴<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003887.pdf>

⁵http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4315&element_id=3638&highlight=2310#r4315

⁶<http://www.facebook.com/press/info.php?timeline#/press/info.php?statistics> — data referenced Nov. 12, 2010.

⁷No “rainbow chickens” or other virtual fowl were harmed in the preparation of this article.

⁸Click here for an executive summary: http://www.naic.org/documents/committees_a_suitability_reg_guidance.pdf

⁹http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=8824