



Risk Management Update May 2008

NEWLY PROPOSED CHANGES TO REGULATION S-P

The SEC's proposed amendments to Regulation S-P include a new exception to the notice and opt-out requirements to allow limited information sharing when representatives move from one firm to another. In the proposing release, the SEC recognizes that representatives may develop close relationships of trust and confidence with their clients and the exception is designed to facilitate the efficient transfer of customer information and allow customers to continue working with their representative at the new firm. The exception addresses the industry practice of transferring customer information when a representative moves to a new firm, but imposes restrictions in order to ensure the information is properly protected. According to the SEC, the exception is designed to permit limited information sharing by establishing an orderly framework under which firms with departing representatives could share certain limited customer contact information and adequately supervise the transfer of information. How does this new exception affect your responsibilities and obligations to adequately to protect customer information? Does the exception sufficiently promote investor choice and the efficient transfer of client contact information? These are just a few of the practical questions that arise under the proposed exception.

What Information May Be Shared and Why?

The type of information that may be disclosed under the exception is that which may be useful for the representative to contact customers with whom the representative had personal contact, but would be unlikely to put the customer at risk of identity theft. As a result the exception limits the permitted information to a customer's name, a general description of the type of account and products held by the customer, and the customer's address, phone number and email contact information. The information cannot include a customer's account number, Social Security number or securities positions.

The SEC admits that permitting the limited transfer of customer contact information when representatives move firms is important to promote investor choice and the efficient transfer of customer accounts. The proposed exception, according to the SEC, is designed to encourage this practice while ensuring that customer privacy is adequately protected throughout the transfer process. Although the exception is supposedly designed to promote investor choice and encourage information sharing, it focuses on the firm with the departing representative and gives that firm absolute control over whether or not any information will be shared.

To reduce the incentive of departing representatives to secretly take customer information, the exception "allows" firms to disclose certain customer information that will permit the representative to contact clients and continue working with them at the

new firm. However, by giving the old firm the exclusive control over the information sharing, the proposed exception does not effectively satisfy its stated goals. If a firm decides not to rely on the exception, firms and representatives will be in the same position that they were in prior to its adoption, and will be required to get explicit customer consent or implicit consent through notice and opt-out procedures prior to transferring any such information.

Implications of the New Information Disclosure Exception

When the SEC adopts the changes to Regulation S-P, the exception permitting disclosure of client contact information may give rise to significant practical considerations firms must consider before utilizing the exception. The exception favors the firm in possession of the information by giving it control over whether to use the exception, creating difficulty in making the process efficient and promoting investor choice. The firm essentially can decide which representatives the firm will allow to take information with them and to which firms.

Firms that do decide to utilize the exception will face uncertain implications if any information outside of the listed conditions is transferred. The departing representative would be in violation for taking unauthorized customer information, even though the firm has the sole control over the use of the exception. Presumably the firm will be liable for disclosing any additional information, but shouldn't the degree of supervision over the transfer process be relevant as well? Additionally, the exception applies equally to all broker-dealers and registered investment advisers, without taking into account any differences in business models, services provided or degree of customer sophistication. To further complicate its applicability, the exception does not apply when representatives transfer to or from banks, state-registered advisers, or other types of financial institutions.

As your firm tests its books and records and privacy safeguard policies and procedures this year, consider the impact of the proposed exception to information sharing practices under Regulation S-P. For more information, please contact us at (619) 278-0020.

Author: Michelle Jacko is CEO of Core Compliance & Legal Services, Inc. ("CCLS") and Managing Partner of Jacko Law Group, PC ("JLG"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on regulatory compliance matters. For more information about this topic and other legal services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com. Thank you.

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