

## Insights

# ONE MONTH IN: TOP 5 TAKEAWAYS FOR U.S. SECURITIES FIRMS IN THE MIDST OF THE PANDEMIC

Apr 09, 2020

U.S. Securities firms are on the frontlines of one of the most volatile economic periods in history. With the Dow Jones Industrial Average flirting with the 30,000 mark in February, few firms could have predicted that the next month would see the largest single day percentage drop in the stock market since 1987 (wiping out \$3 trillion from the 500 biggest public companies), shelter-in-place requirements for most of their employees, and the suspension of all in person FINRA arbitrations and mediations until at least the beginning of May. Even for an industry conditioned by such historical events as Black Monday (1987) and the 2008 Financial Crisis, the events of the past month have been remarkable.

The non-stop news cycle, numerous regulatory edicts, and an anxious client base have made this time a particularly challenging one for firms. As we approach the one month mark of when firms became immersed in responding to pandemic challenges, this alert summarizes five key takeaways.

### Key Takeaways:

- Firms are likely to face a variety of potential litigation threats.
- Business continuity planning has become a key priority and the subject of regulatory scrutiny.
- The SEC and FINRA have responded with various forms of relief.
- The sudden downturn raises many issues that could impact commercial lease arrangements.
- Cybersecurity concerns are in the forefront as many employees are working from home and cyber scams proliferate.

### Planning for Future Litigation/Arbitrations:

Based upon past market downturns, an increase in customer claims is a near certainty. Following the 2008 Financial Crisis, the overall number of FINRA arbitration cases filed increased by 53% in 2008 and again by 43% in 2009, before falling in 2010. Several types of claims saw a particularly

significant rise. Failure to Supervise claims had the biggest jump with a 161% increase in 2009. Claims for Negligence, Unsuitability, Omission of Facts, and Margin Calls all saw an increase of 100% or greater that same year. Breach of Fiduciary Duty was the most cited at 4,206 claims. As for the security product types underlying these cases, Preferred Stock based claims grew by 318% in 2009. Claims involving Corporate Bonds, Certificates of Deposit, Limited Partnerships, and Variable Annuities all more than doubled that year.<sup>1</sup>

The types of claims arising from the pandemic may differ from those following the 2008 Financial Crisis. Since 2008, there has been a substantial migration of business to fee based platforms. One study calculated that from 2008 to 2017, the percentage of assets under management in fee based accounts grew from 26% to 45%.<sup>2</sup> This change will alter the focus of customer claims to fiduciary based claims, including claims that brokers failed to properly monitor accounts.

For traditional commission-based brokerage accounts, there will be an even greater focus on the level of commissions as an indicator of the broker's good faith in making recommendations. Notable in this regard is the advent of the SEC's Regulation Best Interest on June 30, 2020, which will be an immediate focus of OCIE exams thereafter. Also, claims arising out of broker recommendations in sectors that have been particularly hard hit by the pandemic, such as energy, retail, travel and hospitality, finance and banking, are likely. Likewise, firms may face claims arising from the impact of unprecedented market volatility on strategies imbedded in alternative investments and ETFs. Bloomberg Law News reports that Rick Fleming, the SEC's Investor Advocate, recently noted a "widespread lack of understanding" among investors as to how leveraged ETFs operate as losses have accumulated in the market downturn.<sup>3</sup>

In addition to securities-related claims, firms may also face claims arising from operating businesses in pandemics. For example, several actions have already been filed against companies for COVID-19 exposure, including wrongful death actions. As all securities firms must maintain some in person operational employees, potential liability exists on this front.

## **Business Continuity Planning for a Worldwide Pandemic**

In light of the worldwide COVID-19 pandemic, the Financial Industry Regulatory Authority ("FINRA") issued **Regulatory Notice 20-08** to address member firms' obligations with respect to business continuity planning. Firms are generally required to create and maintain a plan that sets out procedures in case of an emergency or other significant business disruption under **FINRA Rule 4370** (Business Continuity Plans and Emergency Contact Information). Given the current global disruption, Regulatory Notice 20-08 encourages member firms to consider whether their current business continuity plans are sufficient to address issues such as staff absenteeism, working remotely, travel limitations and technology interruptions. For example, many firms that relied on staff in India to complete back-office functions are now faced with bringing those operations back to the United States while most of their U.S.-based staff have transitioned to working remotely.

On the bi-weekly podcast, **FINRA Unscripted**, FINRA stated that the “key takeaway” for firms is to focus on their clients. Specifically, firms should make sure that they are adjusting to the current environment so that they can serve their clients to the best of their ability. FINRA noted that firms should be thoughtful about their approach and document the decisions they made.

Member firms are also encouraged to notify FINRA if they activate their business continuity plans or if they are facing issues such as disruption to business operations. In addition, firms should ensure their emergency contact person information is up to date with FINRA. In reminding firms about re-visiting their business continuity plans, FINRA emphasized protecting client assets and keeping employees safe.

## **SEC & FINRA Regulatory Relief**

Both the Securities and Exchange Commission (“SEC”) and FINRA have issued a series of orders and notices providing varying forms of regulatory relief:

### *Form U-4*

FINRA specified in **FINRA Unscripted** that it is focusing regulatory relief on extending reporting deadlines, particularly when paper filings or physical signatures are required. As many registered persons have temporarily relocated their work due to COVID-19, FINRA has also temporarily suspended the requirement that firms update the Form U-4s with the new, temporary address of each registered person. As the situation continues to evolve, updated regulatory guidance from FINRA can be found on **FINRA’s Covid-19 webpage**.

### *Notarized Documents for Form ID*

In addition, the SEC has recognized that obtaining notarized documents may be a challenge under the current circumstances. Filers seeking to make electronic submissions on the SEC’s EDGAR database normally must complete the Form ID and include a notarized document to confirm their authenticity. However, filers may now submit the notarized document up to 90 days after filing the Form ID if the filer could not obtain the notarized document as a result of the COVID-19 pandemic.

### *Form ADV & Form PF Quarterly or Annual Filings*

The SEC also issued an exemptive order on March 25, 2020, which allows investment advisers whose operations have been affected by COVID-19 to temporarily postpone their quarterly or annual Form ADV and Form PF filings. Generally, to register with both the SEC and the state securities authorities, an investment adviser must file Form ADV and provide an annual update. In addition, investment advisers who manage various types of private funds with at least \$150 million in private fund assets under management generally must file a Form PF on a quarterly or annual basis. The SEC’s temporary relief of these filing requirements is now through June 30, 2020 and investment advisers are no longer required to provide the SEC or clients with a reason why the adviser must rely

on the order or when the adviser anticipates being able to meet the requirement. The March 25, 2020 order supersedes the SEC's March 13, 2020 order. Further information on the SEC's response to COVID-19 can be found on their website.

## **Leases**

Many firm's business models rely on a significant real estate footprint. Firms who lease spaces for multiple branch offices are faced with numerous questions, such as: Does any order from any state or local government mandate branch closure or does the applicable branch fall under an exception that will permit its continued operation at some level? Is the landlord continuing to provide access to the branch office? Is the landlord continuing to furnish all services required by the lease? Is there some basis for the branch to cease its rental payments or to request rent relief from the landlord? Has branch revenue been severely impacted leading to an inability to pay rent? If the branch is located in a building with other tenants who are not paying rent, will the building go into foreclosure and will that foreclosure wipe out the firm's lease?

As the impacts of COVID-19 continue and evolve, landlords and tenants are assessing their legal positions. Those assessments include a review of their leases for force majeure (unforeseeable circumstances that prevent the fulfilling of a contract) provisions, among others highlighted in [Commercial Leases - Rent Obligations in the United States](#) and [Eviction and Foreclosure Limitations Across the Country](#), as well as a review of applicable sheltering orders which are issued and update with increasing rapidity. Ideally, all stakeholders (tenants, landlord, investors in the real estate and their lenders and insurers) will work together to find pragmatic solutions to what is hopefully a short term liquidity issue. Firms should be proactive in addressing contingencies with landlords to ensure continuity of business operations in their branches.

## **Cybersecurity:**

The societal changes and economic damage brought on by the COVID-19 pandemic make it all the more important that firms remain vigilant with regards to cybersecurity. The sudden and massive increase in the number of people working from home will place a heavy burden on both firms and employees to maintain best practices. FINRA has published a list of measures for both associated persons and member firms to be utilized during this time. In particular, FINRA has advised that firms should offer frequent training and guidance to associated persons regarding the various cybersecurity risks relating to the new paradigm. Additionally, FINRA has suggested key protective measures for computers & mobile devices, awareness of common types of attacks, well established incident response protocols, and network security controls. The European Union Agency for Cybersecurity has released a simple list of steps employees and employers can take to protect the work from home environment:<sup>4</sup>

For Employees:

- Secure wifi connection.
- Fully updated anti-virus system in place.
- Up to date security software.
- Remember to back up periodically.
- Lock your screen if you work in a shared space.
- Make sure you are using a secure connection to your work environment.
- Check if you have encryption tools installed.

For Employers:

- Provide initial and then regular feedback to staff on how to react in case of problems.
- Give suitable priority to the support or remote access solutions.
- Provide virtual solutions.
- Ensure adequate support in case of problems
- Define a clear procedure to follow in case of a security incident.
- Consider restricting access to sensitive systems where it makes sense.

With a likely increase in phishing attacks, employers are also advised to require multi-factor authentication in order to access any firm networks or email platforms. This should be in addition to regular training on recent cybersecurity events, to raise employee and associated person consciousness regarding the current schemes and scams.

In addition to the threats faced by firms, the current pandemic has also created an environment ripe for investment schemes targeted at firm customers. The NASAA Enforcement Section anticipates that “scammers will be targeting retail investors, capitalizing on recent developments in the economy and preying on concerns about the regulated securities market. NASAA lists six specific categories to watch out for:

- Private placements and off-market securities.
- Gold, silver and other commodities.
- Recovery schemes.
- Get-rich-quick schemes.

- Replacement and swap schemes.
- Real estate schemes.

Similar resources are available from the U.S. Securities and Exchange Commission and individual state securities regulators.

1. *2012 Dispute Resolution Statistics*, <https://www.finra.org/arbitration-mediation/2012-dispute-resolution-statistics>
2. Cerulli Associates, *The Cerulli Edge – U.S. Retail Investor Edition, 1 Q 2019 Issue*, as cited by Ginger Szala, *Have Fee-Based Models Won the Battle...Or the War?*, *Think Advisor News* (February 21, 2019), <https://www.thinkadvisor.com/2019/02/21/have-fee-based-models-won-the-battle-or-the-war/?slreturn=20200308150236>
3. Ben Bain & Katherine Greifeld, *Leveraged ETF Blowups Draw SEC Scrutiny Amid Market Turmoil(2)*, *Bloomberg Law News* (April 8, 2020)
4. European Union Agency for Cybersecurity, *Top Tips for Cybersecurity When Working Remotely*, (March 15, 2020), <https://www.enisa.europa.eu/news/executive-news/top-tips-for-cybersecurity-when-working-remotely>

## RELATED PRACTICE AREAS

- Real Estate
- Broker-Dealer and Investment Advisor Regulatory Enforcement, Disputes and Investigations
- Data Privacy & Security
- COVID-19 / Coronavirus Resources

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