
COVID-19: Key Issues for Broker-Dealers

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Overview

The spread of the coronavirus (COVID-19) has presented new and unique challenges for the securities industry. The typical “playbook” for disaster relief and business continuity planning never contemplated a world – as we have today – where highly interconnected individuals are required to observe social distancing, avoid groups of more than ten persons, and work from home. As firms navigate these uncharted waters, they might take comfort in the fact that even in uncertain times, there are some concrete steps that they can take to mitigate potential legal and regulatory exposure that may result from a dispersed and remote workforce.

Below are eight key issue areas and practice points that broker-dealers and other market participants may consider in a COVID-19 environment. SEC Trading & Markets staff have told us that they are open and receptive to requests for relief and guidance.

1. Who should go into the office?

A fundamental, threshold question firms must answer is “Who should go into the office?” Under federal guidelines, “if you work in a critical infrastructure sector, as defined by the Department of Homeland Security, you have a special responsibility to maintain your normal work schedule.”¹

The financial services sector is identified as a “Critical Infrastructure Sector” by the Department of Homeland Security. Under this guidance, financial services sector workers are essential critical infrastructure workers during the COVID-19 response emergency.²

In addition to the federal guidelines, many if not most states and some counties and cities have issued “shelter at home” orders. As a general matter, essential workers in “essential services” may

be exempt from these laws, however, each shelter in place order must be carefully reviewed and analyzed to determine how “essential services” is defined.³

Practice points:

- Identify essential workers who should go into the office (e.g., who cannot effectively perform their central job functions through teleworking). Financial firms whose essential staff may be traveling to critical facilities during hours when shelter-in-place directives are in force should consider physically carrying on their persons:
 - The Financial Services Sector memo from the U.S. Secretary of the Treasury;⁴
 - A government-issued ID; and
 - Any letter provided by their employer, on company letterhead.
- Identify and monitor third parties (vendors) on which the firm relies – are they covered as essential services? Are they able to continue to perform services on your behalf? If the answers to these questions are “yes”, consider contacting those vendors to confirm that they are continuing to operate to provide essential services. It is advisable to document such an understanding in writing.
- Stay up-to-date on federal and state laws and guidance on who can go into office, as well as policies for what a business is required to do for workers who do come into the office – they are evolving every day.

2. Supervision & Remote Locations (Working from Home): What are the Regulators’ Expectations?

In 2004, the SEC detailed best practices for supervising remote locations.⁵ While these guidelines are targeted for “normal” times, the following practices are relevant here:

- Firms should leverage centralized technology to monitor the trading and handling of funds in remote office accounts in order to detect misappropriation of customer funds, selling away, and unauthorized trading, among other things.
- “Red flags” that raise particular concern when conducted in remote locations include: (i) receipt of checks made payable to a representative or any outside business of a representative; (ii) opening of a bank account in the firm's name or any name similar to the firm's name by a representative; (iii) receipt of cash and securities by a representative; (iv) frequent or questionable transfers of funds or securities between customer accounts; (v) use of a post office box or an address associated with the representative for customer accounts; and (vi) transfer of customer funds or securities to employee accounts without supervisory approval.
- Effective monitoring also may include contacting a random sampling of customers to make general inquiries or to inquire about specific account activities.

- Personnel should not be permitted to use personal computers or personal devices not connected to the firm’s network for conducting business.⁶

Over the years, FINRA has issued guidance on disaster preparedness and related regulatory issues associated with working remotely.⁷ FINRA updated its remote office and telework guidance to address the COVID-19 pandemic:⁸

- Reasonably designed supervisory system – Firms should establish and maintain a system that is reasonably designed to supervise the activities of each associated person while working from an alternative or remote location during a pandemic.
- Testing – Before broadly activating a business continuity plan, FINRA recommends firms test the ability to connect to critical firm systems, the adequacy of remote connectivity via residential internet access networks and any potential need to secure premium or dedicated service for connectivity.
- Onsite inspections may be delayed – FINRA understands the use of remote offices or telework arrangements during a pandemic may necessitate a member firm to implement other ways to supervise its associated persons who change their work locations. For example, a firm’s scheduled on-site inspections of branch offices may need to be temporarily postponed during the pandemic.

Practice points:

- Review regulated functions and assess if enhanced or modified surveillance is required, depending on the function and potential enhanced risks these functions raise when personnel work from locations, e.g.:
 - Sales and Trading (suitability, front running, safeguarding confidential order information, unauthorized trading);
 - Investment banking (safeguarding MNPI);
 - Research (safeguarding material nonpublic research information);
 - Back office and Operations (propriety of cash & securities movements);
 - Finance (access to liquidity, maintaining required net capital and customer reserves, and access to the Primary Dealer Credit Facility); and
 - Vendor personnel (in particular, those who perform a function necessary to satisfy a legal or regulatory obligation).
- Review remote personnel to assess whether any individuals have a disciplinary background that may warrant enhanced or additional surveillance while they are working remotely.

- Identify areas of increased risk across all personnel, when working remotely and assess whether additional or enhanced supervision is required to address these risks, e.g.:
 - Insider trading and compliance with Section 15(g) – controlling information and maintaining barriers requires increased focus with a dispersed staff.⁹
 - Be wary of “political intelligence” and trading on rumors. Information that is not company specific may be material and sensational.
 - Position valuations must be current in a mark to market environment.
 - Look for patterns of money movements from registered reps to customers, handling customer cash/securities from remote locations, and change of address.
 - Be alert to improper steps to avoid margin calls (e.g., procedures to avoid improper employee loans to customers).
 - Review for increased personal trading activity.
 - Consider suitability of recommendations in a volatile environment (buy/hold/sell; options trading, including by newly qualified accounts).
- Documenting updated procedures. The use of remote offices or telework arrangements during a pandemic may require other ways to supervise associated persons who change their work locations or arrangements for the duration of the pandemic. In such cases, FINRA expects firms to establish and maintain a supervisory system that is reasonably designed to supervise the activities of each associated person while working from an alternative or remote location during the pandemic, and to document any changes to its current written supervisory procedures.¹⁰

3. Cybersecurity & Remote Locations (Working from Home)

Cybersecurity is a critical concern as there is evidence that criminals are exploiting the coronavirus online. The risk is higher with more people working from home, and attacks are likely to increase the longer the pandemic continues.

Practice points: Firms should review their systems infrastructure to confirm that:¹¹

- VPNs are properly patched;
- System entitlements are current;
- Firewalls are working;
- Multi-factor authentication is used, as appropriate;
- Employees are provided with regular reminders of cyber risk; and
- Employees are not storing files locally and instead connect remotely to the firm’s own servers.

4. Business Continuity Plan (“BCP”)

FINRA BCP guidance provides that firms:¹²

- Create, maintain and annually review the plan to ensure it addresses key risk areas;
- Analyze risks in devising the plan;
- Disclose the plan to customers; and
- Provide FINRA with key contact information that is keep current.

Practice points:

- Review key risk areas and update the BCP, to the extent practices evolve during the pandemic, i.e.: (i) back up data/recovery; (ii) financial and operational assessments; (iii) communications with customers; (iv) physical locations; (v) critical counterparty impact; (vi) regulatory reporting; (vii) communications with regulators; and (viii) availability of customer funds and securities.
- Update Forms BD if business is conducting in a new state. (U4/U5 office address information requirement suspended.)
- Identify new offices to the firm’s FINRA Risk Monitoring Analyst, i.e.: (i) names of registered personnel and contact person; (ii) duration; (iii) space sharing – need to attend to information control in shared space; and (iv) identification of customers.

5. Personnel-Related Issues

Remote working patterns will result in a delay in “business as usual” hiring and consideration of new legal areas.

Practice points: Below are key areas relating to personnel in a “work from home” environment.

- Labor law and worker safety/OSHA issues – confirm remote working conditions conform to federal labor law and worker safety/OSHA requirements.
- Privacy/health law issues – confirm the firm’s protocol for personnel who have been exposed or are diagnosed with the virus complies with privacy and health laws.
- New hires/fingerprinting:
 - SEC issued an order exempting firms from the fingerprinting requirements until May 30, 2020.¹³
 - FINRA extended the time to submit fingerprints until June 29, 2020.
- U4/U5 filings:
 - Registration testing centers are closed; dates are being rescheduled.

- Conditional exemption from wet signature requirement.
- Expiring qualification examinations winds are being extended until May 31; individuals who were designated to function as principals under Rule 1210.04 prior to February 2, 2020 will be given until May 31, 2020 to pass the examination. FINRA will assess whether additional time might be necessary.

6. Operations and Back office Functions

Operations and back-office functions are among the most difficult to transition to a “work at home” environment and with calls for “social distancing,” there are likely to be increased strain on these functions.

Practice points: Below are key issue areas that may be impacted by these strains and that firms may consider monitoring on an enhanced basis.

- Customer funds and securities (certification and check handling; customer access to funds and securities; reserve formula computations and deposits);
- New customers and ACAT processing;
- Compliance with customer protection rule (reserve deposit require qualified securities or cash);
- Margin (collateral calls, close outs, Reg T extensions);
- Clearance and settlement (collateral at and obligations to clearing agencies, fails to receive, customer long sales, close out requirements, extensions of settlement); and
- Hard copy communications with customers (issues with use of US mail and mail room capacity, delivery of confirmations, account statement, and prospectuses).

7. Trading & Markets Issues

With extreme volatility and collapsing prices, rules relating to market integrity, credit events, and risk controls are more likely to be triggered and require increased attention.

Practice points: Below are key areas that are likely to be implicated in these volatile markets.

- Online access/resiliency – Firms may experience significantly increased customer call volumes or online account usage. If registered representatives are unavailable to service their customers, firms should consider placing a notice on their websites indicating to affected customers who they may contact concerning the execution of trades, their accounts, and access to funds or securities.
- Satisfying best execution – Evaluating a broker-dealer’s satisfaction of its duty of best execution necessarily requires a “facts and circumstances” analysis. While broker-dealers are not relieved of their best execution obligations in these circumstances, FINRA has

noted that the reasonable diligence required for best execution is assessed in the context of the characteristics of the security and market conditions, including price, volatility, relative liquidity, and pressure on available communication.¹⁴

- Short sale considerations – As market participants anticipate further market disruption, the volume of short sales may increase, putting more pressure on processes around (i) circuit breakers (restrictions on trading when in effect and monitoring exceptions); and (ii) locates (are securities hard to borrow?); and (iii) close out requirements.
- Cash Account settlement – Timely payment for purchases, delivery for sales, requests for extensions, acceptance in good faith of customer’s willingness and ability to pay for securities purchased or deliver securities owned and sold.
- Algorithmic trading, Rule 15c3-5, and systems capacity: The current unprecedented volatility may also require firms to review and recalibrate: (i) risk controls/alert parameters (and relatedly, downstream effects of changes; (ii) systems capacity; (iii) credit and capital controls (are the controls still appropriate given change in market and client circumstances?); (iv) best execution assessments; (v) pre-trade regulatory controls; (vi) compliance surveillance parameters; and (vii) to the extent relevant, Regulation SCI (for ATSS).
- Trade reporting: Consider contingency plans/response for OTC trading and reporting in the event the of an issue with a FINRA facility.
- Contracts – In a volatile market, contract issues are likely to arise relating to (i) disputes, (ii) defenses to performance, and (iii) valuation/collateral.

8. Engaging with the Regulators

As firms are not operating under normal conditions, delays are to be expected and expectations will need to be managed.

Practice points: Expect delays in cases, testimony, settlements, and anticipate collateral consequences. Assess whether relief may be required for regular filings (e.g., FOCUS and Annual report filing (17a-5(d)(5)).

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¹ See March 22, 2020 Financial Services Sector Memorandum from US Secretary of Treasury, at <https://www.sifma.org/wp-content/uploads/2020/03/Financial-Services-Sector-Essential-Critical-Infrastructure-Workers.pdf>.

² See March 19, 2020 CISA Guidance, at <https://www.cisa.gov/publication/guidance-essential-critical-infrastructure-workforce>.

³ For a discussion of the NY, CA, NJ, MA, at CT state orders, see: <https://www.wilmerhale.com/en/insights/client-alerts/20200320-governor-cuomo-issues-emergency-work-from-home-requirements-for-new-york-employers>; <https://www.wilmerhale.com/en/insights/client-alerts/20200323-covid-19-an-overview-of-governor-newsoms-statewide-shelter-in-place-order>; <https://www.wilmerhale.com/en/insights/client-alerts/20200322-covid19-new-jersey-governor-phil-murphy-orders-employers-to-reduce-onsite-staff-and-closes-nonessential-retail-stores>; <https://www.wilmerhale.com/en/insights/client-alerts/20200323-mass-governor-issues-covid19-stay-at-home-order-guidance-for-massachusetts-businesses>; <https://www.wilmerhale.com/en/insights/client-alerts/20200325-covid-19-connecticut-imposes-on-site-workplace-restrictions-and-issues-guidance-for-exempted-essential-employers-and-those-deemed-non-essential>.

⁴ See *id.* at n.1.

⁵ See Division of Market Regulation Staff Legal Bulletin No. 17, Remote Office Supervision (March 2004), available at <https://www.sec.gov/interps/legal/mrslb17.htm>.

⁶ In SG Cowen and Lehman Brothers, for example, Frank Gruttaduria had a personal computer that was networked to computers used by other employees of the firm but not to the firm-wide system and used this computer to generate false statements and reports, among other things. See SG Cowen Securities Corp., Release No. 34-48335 (Aug. 14, 2003); Lehman Brothers, Inc., Release No. 34-48336 (Aug. 14, 2003).

⁷ See, e.g., FINRA Regulatory Notices 09-59, available at <https://www.finra.org/rules-guidance/notices/09-59>; NASD Notice to Members 06-74, available at <https://www.finra.org/rules-guidance/notices/06-74>.

⁸ FINRA Regulatory Notice 20-08, available at <https://www.finra.org/rules-guidance/notices/20-08>. See also <https://www.wilmerhale.com/en/insights/client-alerts/20200310-finra-issues-guidance-and-regulatory-relief-related-to-covid-19>.

⁹ See also Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity, available at <https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity>.

¹⁰ See FINRA Frequently Asked Questions Related to Regulatory Relief Due to the Coronavirus Pandemic, available at <https://www.finra.org/rules-guidance/guidance/faqs/coronavirus>.

¹¹ See also FINRA Regulatory Notice 20-08 (discussing the importance of cybersecurity for remote working situations), available at <https://www.finra.org/rules-guidance/notices/20-08>.

¹² See FINRA Rule 4370.

¹³ See Exchange Act Release No. 8848 (March 20, 2020).

¹⁴ See FINRA Frequently Asked Questions Related to Regulatory Relief Due to the Coronavirus Pandemic, available at <https://www.finra.org/rules-guidance/guidance/faqs/coronavirus>.