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Issues in Consolidated Investment Reporting for Customers

Introduction

Securities firms frequently offer customers consolidated financial account reports, prepared by third party entities, that provide clients with valuation and performance information for all of their assets, including those held away from the firm. Because such services (referred to as "consolidated reports" or "consolidated reporting") are becoming increasingly commonplace, securities firms risk losing a competitive edge by not offering such statements or reports. However, regulators have placed Member firms on notice that consolidated reporting raises a host of potential regulatory and compliance issues. This article will synthesize some pertinent guidance on the use of third party consolidated reporting and outline some best practices for their use.

Regulatory Risks Presented by Consolidated Reports

Firms use several means to consolidate information from clients' multiple accounts, including internal data gathering and integration systems, use of software applications like Microsoft Excel spreadsheets, and fully outsourced third party vendor services from companies such as Albridge Wealth Management, DST Vision Professional, and Morningstar Snapshot. The reports themselves can take a variety of forms, and can be customized by a representative for a particular customer, or they can be a standardized report by a firm-wide system. The Financial Industry Regulatory Authority (FINRA) considers these reports to be communications with the public, which can create a number of regulatory concerns, including the "potential for communicating inaccurate, confusing or misleading information to customers, lapses in supervisory controls, and the use of these reports for fraudulent or unethical purposes."[1] Because such problems can arise if such reports are not "rigorously supervised," firms are

[1] FINRA Notice to Members (NTM) 10-19 (April 2010).

"strongly encouraged" to review the adequacy and effectiveness of applicable supervisory procedures.[2] Both the firm and the registered representative are responsible for compliance with applicable rules, and firms cannot delegate compliance duties onto representatives[3] or to third parties.[4]

The main regulatory concern—and corollary litigation risk—is that, by providing consolidated reports, firms are impliedly representing that they themselves have produced or verified the data contained in such reports.[5] Relatedly, customers and third parties such as their banks, mortgage companies, or other broker-dealers, may be confused or misled as to the information regarding those reported assets.[6] Consolidated account statements, as the name implies, gather and present customer information for assets held at the firm and those held away from the firm. For assets held at the firm, one risk is that the information is inconsistent with the customer's official account statement.[7] Since the new suitability rule requires a more comprehensive analysis of a client's financial profile, an argument may be made that a firm should reconcile any inconsistencies before making an investment recommendation and, moreover, inquire of the client as to the existence of such consolidated account reports even if they are provided by another broker-dealer firm at which the customer maintains an account. For assets held elsewhere, one risk is that the information is inaccurately reproduced or is deemed inaccurate or misleading.[8] Even minor clerical errors, such as reproducing a sponsor's incorrect listing of a ticker symbol for its more valuable freely-traded shares, which artificially inflates the value of restricted private placement shares, can create triable issues as to a firm's knowledge of another's misrepresentations.[9] Those risks are multiplied when reporting information is held and/or produced by multiple external sources.

The duty to supervise consolidated reports creates particular problems for valuation of illiquid and non-conventional investments. In a recent regulatory settlement with FINRA, a brokerage firm was censured and fined for, among other things, failing to keep in place an adequate supervisory system for the review, approval and use of consolidated reports.[10] Contrary to the firm's instructions, a representative manually entered valuation information which misled his clients. Although the firm provided standardized valuation data for illiquid investments and prohibited its agents from using the

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[2] *Id.* at 1.
[3] See *In re VSR Financial Services*, Letter of Acceptance, Waiver, and Consent, FINRA 2010022963602 (May 15, 2013), discussed further below.
[4] NTM 05-48 (July 2005).
[5] See NTM 10-19, at 3.
[6] *Id.* at 2.
[7] Provided by the firm under NASD Rule 2340 and NYSE Rule 409.
[8] *Id.*; NASD Rule 2340(c) ("Customer Account Statements").
[9] See, e.g., *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities*, 652 F. Supp. 2d 495 (S.D.N.Y. 2009).
[10] *VSR Financial Services*, FINRA 201022963602 at 7. In that case, FINRA found multiple violations, so the censure and fine ($550,000) do not relate solely to the supervision of consolidated reports.

original cost basis as current value when the representative was aware that values had declined, the firm's failure to have a pre-approval or review process for the consolidated reports was determined to be unreasonable.[11]

FINRA has also identified a non-exhaustive list of factors that increase the difficulty of conforming consolidated reports with rule requirements: (a) provision of large number of varying types of consolidated reports, especially when they are highly customizable; (b) reporting on a wide variety of asset classes, especially those held away; and (c) a decentralized structure employing multiple reporting systems.[12]

Consolidated Report Best Practices

Firms should employ practices and procedures that are reasonably designed to ensure the accuracy of consolidated report information and, if unable to validate that data for non-held assets, clearly and prominently disclose that such information is unverified.[13] Effective controls to ensure attainment of these goals would include a pre-approval process for consolidated report templates and, for programming that enables report customization, controls over that customization. This may include review of the process as a standard element in a firm's oversight and audits, including review for regulatory compliance, data accuracy, and conformance with firm procedures. It should also entail a written agreement with the vendor attesting to the development of procedures for reviewing and testing the accuracy of information.[14] For NYSE members, this process must be explained in statements provided in writing to the Exchange in advance. Rule 409(a)/3 ("Use of Third Party Agents").

At the outset, a customer should be informed about the nature and limitations of the consolidated reporting process, and firms are well-advised to provide those disclosures in writing, receive a signed acknowledgment of such disclosures, and refresh this notice periodically.[15] FINRA has identified particular disclosures that firms are "encouraged to include" in consolidated reports:

- That the consolidated report is provided as a courtesy for informational purposes, and may include assets not on the firm's books and records;
- The names of entities holding the assets or providing the source data, and their relationships with each other;

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[11] *Id.* at 8.
[12] NTM 10-19, at 3.
[13] NTM 10-19, at 3.
[14] NYSE Rule 409(a) /06(4)
[15] NTM 10-19, at fn.2.

- Statements and formatting[16] clearly distinguishing between assets, or categories of assets, held by each entity;
- The account number and contact information for customer service at each entity in the consolidated report;
- Statements that assets held away may not be covered by the Securities Investor Protection Corporation;
- If the report provides aggregate values for several different assets, an explanation of how those values were arithmetically derived from the separate asset totals;
- Statements encouraging customers to review and maintain the original source documents integrated into the consolidated report, explaining their importance for notices, other disclosures, and as references for accuracy of information[17]; and
- For DPPs and REITs, statements that they are generally illiquid, that the value will be different from the purchase price, and, if applicable, that accurate information is not available.[18]

Some firms have adopted the following practices: requiring branch offices to obtain annual third party audits of the process; utilization of a single firm-wide system; in the case of multiple report-producing systems, a single review and approval process involving information technology, compliance, and legal departments; and ensuring that consolidated reports and account statements are sent to the same address of record, or having documentation explaining situations where statements and reports are sent to different addresses. [19]

Arguably the most important safeguards relate to information regarding the valuation and performance of externally-held assets, particularly when those are not publicly traded or are illiquid. FINRA implicitly approved of procedures to verify such information, or at least the maintenance of supporting documentation such as the source of data and methods used to determine accuracy and asset valuation.[20] Firms can also minimize risks related to valuation issues by ensuring that their compliance policies for outsourcing services are extended to consolidated reporting services. Firms could follow the example of most members supervising outsourced work by: using programmatic checks through business operations, including procedures in contracts, requiring periodic status reports and

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[16] NYSE Rule 409(a)/06(1)(c) requires the use of columns, coloring, or other distinct form of demarcation distinguishing between assets held by each entity. NYSE Rule 409(a)/06(3) further provides that, where the consolidated report aggregates separate statements (e.g., brokerage, mutual fund, banking, insurance), the beginning and end of each be clearly distinguishable by color, pagination, or other distinct form of demarcation.
[17] NTM 10-18, at 5-6.
[18] NASD Rule 2340. Estimated values of DPPs or REITs are also subject to additional conditions regarding per share estimated value and the source of such information. Those conditions are likely to be altered soon under a revived proposal to amend the rule regarding reporting of per share estimated values. Notice to Members 12-14 (March 2012).
[19] NTM 10-19, at 4-5.
[20] NTM 10-19, at 5.

meetings, as well as testing and reviewing the third parties' procedures.[21] And of course, the cornerstone of any decision to engage with a third party must include thorough and documented due diligence of the provider, including ongoing monitoring of the vendor's compliance with contract terms as well as its continued fitness and ability to perform consolidated reporting services.

Conclusion

Firms may find themselves forced to offer consolidated reporting to their customers, or risk being at a competitive disadvantage. The response to customer demand may be well-intentioned, and indeed could be seen as increasing the amount of information available to the customer, but it presents a host of regulatory and litigation risks as well. Proper provision of consolidated reporting requires attention to the rules governing communications with the public, customer account statements, valuation of DPPs and REITS, and outsourcing services to third parties.

Anyone who would like additional information or guidance about navigating the issues discussed in this article should feel free to contact us.

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[21] NTM 05-48, at 2.