

QUARTERLY COMPLIANCE NEWSLETTER

(2ND QUARTER, 2012)

The Compliance staff is available to provide guidance regarding regulatory issues. Additionally, one of the primary goals of your Compliance Department is to keep all representatives informed of PCS policies and procedures, the use of best practices, and changes in industry rules and regulations. In order to assist with this goal, and in addition to periodic Compliance Alerts, Quarterly Compliance Newsletters will also be distributed. The information contained in our newsletter should be reviewed by all representatives and used to help clarify an existing policy or procedure, industry rule or regulation.

Topics included in this newsletter include:

- New Suitability Rule FINRA 2111
- Firm Element CE – Coming Soon
- Fee Based Account Conversions
- Branch Audits
- Updated WSP and IA Manual
- Unregistered Assistants – What can they do? (FINRA 1042)
- Blotter (Books and Records) Reminder

New Suitability Rule FINRA 2111:

Effective July 9, 2012 FINRA Rule 2111 is required to be incorporated into each member firm's policies and procedures. The new rules cover various customer related communications and suitability requirements.

The new suitability rule lists in one place the three main suitability obligations: reasonable-basis, customer-specific and quantitative suitability.

- **Reasonable-basis suitability** requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the firm's or associated person's familiarity with the security or investment strategy. A firm's or associated person's reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.
- **Customer-specific suitability** requires that a broker have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. As noted above, the new rule requires a broker to attempt to obtain and analyze a broad array of customer-specific factors.
- **Quantitative suitability** requires a broker who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. Factors such as turnover rate, cost-equity ratio and use of in-and-out trading in a customer's account may provide a basis for finding that the activity at issue was excessive.

The new rule makes clear that broker-dealers and their registered representatives must have a firm understanding of both the product and the customer. It also makes clear that the lack of such an understanding itself violates the suitability rule.

In order to comply with the new rules, PCS has developed a new Customer New Account form which was rolled out to the field in mid-June, 2012. The major changes include increased detail related to: a customer's investment experience; information related to all investments held by the customer, whether held in accounts with PCS or outside of PCS; and changes to the time horizon expectation that the client intends to utilize the investment account. The new Customer New Account form must be used to open all new accounts effective July 1, 2012.

The new rules also require the updated suitability information must be obtained for any account established prior to July 9, 2012 when a recommendation is being made. In order for a registered representative to recommend a purchase, sale, or hold to an established client, the suitability update form must be completed and submitted to Operations so the account suitability may be updated on the system. The good news is that the client is not required to sign the update form UNLESS there is a change to the investment objective on the account. The update form may be completed by the representative based on information obtained from the client.

The new rules also define a HOLD recommendation. If a representative recommends that a client "hold" a position, including the positions contained within a variable product (sub-account allocation), the representative should make note of the recommendation either in the notes tab on NetX360 for brokerage accounts, or in the client file for direct business accounts.

From FINRA Regulatory Notice 11-02: The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case. That remains true under new Rule 2111. FINRA reiterates, however, that several guiding principles are relevant to determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule. For instance, a communication's content, context and presentation are important aspects of the inquiry. The determination of whether a "recommendation" has been made, moreover, is an objective rather than subjective inquiry.

An important factor in this regard is whether -- given its content, context and manner of presentation -- a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation.

Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program.

As a registered representative, it is important that any time you are creating, reviewing, and/or disseminating correspondence you fully understand all the potential Rule 2111 suitability implications.

(See attached FINRA Regulatory Notice 11-02)

Firm Element CE – Coming Soon:

PCS will again be utilizing the RegEd system to deliver our 2012 Firm Element Continuing Education program. The program has been developed based on numerous factors including but not limited to; representative feedback, industry changes, senior management input, and required course selection. Each representative will be required to complete both mandatory courses and elective courses. The 2012 program will also include four education courses for home office staff and assistants.

In addition to the Firm Element CE, the Annual Compliance Questionnaire and Annual Compliance Meeting will also be completed using the RegEd system. All three modules (CE, ACQ and ACM) will be released at the same time and will be available for completion immediately. The release date is scheduled for August 1st, and must be completed by October 30th, 2012.

The cost of the continuing education program will be \$125 for all representatives and managing principals, and \$100 for assistants. The RegEd system will request payment for the program when you sign in the first time, the same way it did in 2011.

The RegEd System will allow users to complete additional training courses that may be used to satisfy insurance and other designation continuing education requirements. These courses are not required as part of the 2012 firm element training program but made available by PCS at no additional charge as an added benefit to all representatives. The additional courses may or may not include additional costs for certificates depending on the use of the CE credit earned. The RegEd website has additional explanations related to any additional costs.

Fee Based Account Conversions

You are reminded that you must have “reasonable grounds” for believing a fee-based program is appropriate for a particular customer, taking into account the services provided, projected cost to the customer, alternative fee structures available and the customer’s fee structure preferences. You should have written documentation supporting the appropriateness of each fee-based account. Based on the customer’s trading history, fee-based accounts may not be appropriate for “buy and hold” customers. If you disclosed a potential lower cost account is available, but the customer nevertheless opted for a fee-based account, you should document the fact that the customer chose a fee-based account for reasons other than cost. The use of margin, holding mutual funds or restricted stock, or recommending fee-based accounts to income oriented conservative or retired investors may not be appropriate. Always maintain complete notes in the client file or contact management system to support an account conversion or managed account recommendation.

Branch Audits

The 2012 branch audit season has begun and all registered branch locations should be prepared to be inspected at any time. Branch inspections will be completed on both an announced and unannounced basis. PCS has contracted with Bill Stone to assist in completing the branch inspections for 2012. Please treat him as an extension of the Compliance Department if he arrives at your office to complete and inspection.

The inspection protocol has been changed for 2012 and includes a number of new review topics compared to past years. Your designated Managing Principal has been provided with guidance to assist you in preparing for the 2012 inspection and it is highly recommended that you contact your MP to review the inspection guidelines.

Updated WSP and IA Manual

There have been many new updates and revisions made to the Written Supervisory Procedures, and all representatives are encouraged to review the NRS website to view the updates. To assist in your review below is a breakdown of the new sections and updated sections. Please take some time to review the WSP’s and direct questions to your designated Managing Principal.

New Sections

- Communications with the Public: Recommendations (Rule 2111)
- Liquefied Home Equity Recommendations
- Posting Book
- Know Your Customer: Retail
- Suitability: Institutional Accounts
- Suitability: Main Suitability Obligations Under FINRA Rule 2111
- Suitability: Investment Recommendations
- Updating Client Information

Updated Sections

- Certificate of Deposit
 - Customer Accounts
 - Debt Securities
 - High Yield Investments
 - Social Networking
 - Limited Partnerships
 - Municipal Securities (including 529 College Savings Plans)
 - Mutual Funds
 - Options
 - Penny Stocks
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Reminder - Unregistered Assistants, what can they do? (FINRA 1042)

Unregistered persons MAY contact prospective customers for purposes of:

- Extending invitations to firm-sponsored events at which any substantive presentations and account or order solicitation will be conducted by appropriately registered personnel;
- Inquiring whether the prospective customer wishes to discuss investments with a registered person; and
- Determining whether the prospective customer wishes to receive investment literature from the firm.

Unregistered persons may NOT discuss general or specific investment products or services offered by PCS, solicit new accounts or orders, or pre-qualify prospective customers as to financial status, investment history and objectives. Unregistered Assistants should not provide any investment literature to a member of the public or client directly. Any distribution of sales literature (including prospectus) should be sent on registered representative letterhead under representative signature, or the assistant may have their own approved letterhead as long as the letterhead identifies who the representative is, and that securities and/or advisory product is offered by the representative. Under no circumstances may sales literature or any securities related correspondence be sent to a client using letterhead that does not include the PCS disclosure. (KFG Letterhead without disclosure should NOT be used for PCS business).

Reminder - Blotter (books and records) requirements:

Pursuant to the Securities and Exchange Act of 1934 Rule 17a-3 (a) and NASD Notice to Members 01-80, you are required to maintain blotters. Blotters represent original order entry (trade tickets) for PCS and must be current at all times. Specifically, PCS policy requires that blotters are completed at the time of order origination, no later than daily and submitted to your designated Managing Principal weekly on Monday for transactions recorded the prior week. As discussed in the following cases, disciplinary action and fines have been levied against broker-dealers and registered persons for failure to maintain books and records, including blotters; FINRA Dept. of Enforcement v. Merrimac Corporate Securities, Inc. (No. 2007007151101), FINRA Dept. of Enforcement v. Max International Broker-Dealer Corp. (No. 20070072538-03), etc.

Please remember that blotters must list the time the order was received from the customer and the time the order was entered into NetX360 (for RKF accounts and/or internet and phone orders for direct business). The security description should be specific to the stock, bond, mutual fund, etc. you are trading. Simply putting American Funds does not satisfy the books and records requirement.

Questions related to any of the information discussed in this newsletter should be directed to your designated Managing Principal.