Study on Investment Advisers and Broker-Dealers

As Required by Section 913 of the
Dodd-Frank Wall Street Reform
and Consumer Protection Act



This is a Study of the Staff of the
U.S. Securities and Exchange Commission

January 2011

This is a study by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

Executive Summary

Background

Retail investors seek guidance from broker-dealers and investment advisers to manage their investments and to meet their own and their families' financial goals. These investors rely on broker-dealers and investment advisers for investment advice and expect that advice to be given in the investors' best interest. The regulatory regime that governs the provision of investment advice to retail investors is essential to assuring the integrity of that advice and to matching legal obligations with the expectations and needs of investors.

Broker-dealers and investment advisers are regulated extensively, but the regulatory regimes differ, and broker-dealers and investment advisers are subject to different standards under federal law when providing investment advice about securities. Retail investors generally are not aware of these differences or their legal implications. Many investors are also confused by the different standards of care that apply to investment advisers and broker-dealers. That investor confusion has been a source of concern for regulators and Congress.

Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requires the U.S. Securities and Exchange Commission (the "Commission") to conduct a study (the "Study") to evaluate:

- The effectiveness of existing legal or regulatory standards of care (imposed by the Commission, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers; and

- Whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.

Section 913 also includes 14 items that must be considered in conducting the Study. The considerations address the following areas, among others:

- Whether retail customers understand or are confused by the differences in the standards of care that apply to broker-dealers and investment advisers;

- The regulatory, examination, and enforcement resources to enforce standards of care;

- The potential impact on retail customers if regulatory requirements change, including their access to the range of products and services offered by broker-dealers;

- The potential impact of eliminating the broker-dealer exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940 (the "Advisers Act"); and

- The potential additional costs to retail customers, broker-dealers, and investment advisers from potential changes in regulatory requirements.

As required by Section 913, the Study describes the considerations, analysis and public and industry input that the Staff considered in making its recommendations, and it includes an analysis of differences in legal and regulatory standards in the protection of retail customers relating to the standards of care for broker-dealers, investment advisers and their associated persons for providing personalized investment advice about securities to retail customers.

The Commission established a cross-Divisional staff task force (the "Staff") to bring a multi-disciplinary approach to the Study. The Commission also solicited comments and data as part of the Study and received over 3,500 comment letters. The Staff reviewed all of the comment letters, and appreciates commenters' thoughtful efforts to inform the Staff and to raise complex issues for consideration. The Staff also met with interested parties representing investors, broker-dealers, investment advisers, other representatives of the financial services industry, academics, state securities regulators, the North American Securities Administrator Association ("NASAA"), and the Financial Industry Regulatory Authority ("FINRA"), which serves as a self-regulatory organization ("SRO") for broker-dealers.

This Study outlines the Staff's findings and makes recommendations to the Commission for potential new rulemaking, guidance, and other policy changes. These recommendations are intended to make consistent the standards of conduct applying when retail customers receive personalized investment advice about securities from broker-dealers or investment advisers. The Staff therefore recommends establishing a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that is consistent with the standard that currently applies to investment advisers. The recommendations also include suggestions for considering harmonization of the broker-dealer and investment adviser regulatory regimes, with a view toward enhancing their effectiveness in the retail marketplace.

The views expressed in this Study are those of the Staff and do not necessarily reflect the views of the Commission or the individual Commissioners. This Study was approved for release by the Commission.

Current State of the Investment Adviser and Broker-Dealer Industries

Investment Advisers: Over 11,000 investment advisers are registered with the Commission. As of September 30, 2010, Commission-registered advisers managed more than $38 trillion for more than 14 million clients. In addition, there are more than 275,000 state-registered investment adviser representatives and more than 15,000 state-registered investment advisers. Approximately 5% of Commission-registered investment advisers are also registered as broker-dealers, and 22% have a related person that is a broker-dealer. Additionally, approximately 88% of investment adviser representatives are also registered representatives of broker-dealers. A majority of Commission-registered investment advisers reported that over half of their assets under management related to the accounts of individual clients. Most investment advisers charge their clients fees based on the percentage of assets under management, while others may charge hourly or fixed rates.

Broker-Dealers: The Commission and FINRA oversee approximately 5,100 broker-dealers. As of the end of 2009, FINRA-registered broker-dealers held over 109 million retail and institutional accounts. Approximately 18% of FINRA-registered broker-dealers also are registered as investment advisers with the Commission or a state. Most broker-dealers receive transaction-based compensation.

Regulation of Investment Advisers and Broker-Dealers

The regulatory schemes for investment advisers and broker-dealers are designed to protect investors through different approaches. Investment advisers are fiduciaries to their clients, and the regulation under the Advisers Act generally is principles-based. The regulation of broker-dealers governs how broker-dealers operate, for the most part, through the Commission's antifraud authority in the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), specific Exchange Act rules, and SRO rules based on Exchange Act principles, including (among others) principles of fairness and transparency. Certain differences in the regulation of broker-dealers and advisers reflect differences, current and historical, in their functions, while others may reflect differences in the regulatory regime, particularly when investment advisers and broker-dealers are engaging in the same or substantially similar activity. The recommendations listed in the Study are designed to address gaps in the regulatory regime, as well as differences in approach that are no longer warranted, as they relate to providing personalized investment advice about securities to retail customers.

Investment Advisers: An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care. An adviser that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to the conflict.

In addition, the Advisers Act expressly prohibits an adviser, acting as principal for its own account, from effecting any sale or purchase of any security for the account of a

client, without disclosing certain information to the client in writing before the completion of the transaction and obtaining the client's consent.

The states also regulate the activities of many investment advisers. Most smaller investment advisers are registered and regulated at the state level. Investment adviser representatives of state- and federally-registered advisers commonly are subject to state registration, licensing or qualification requirements.

Broker-Dealers: Broker-dealers that do business with the public generally must become members of FINRA. Under the antifraud provisions of the federal securities laws and SRO rules, including SRO rules relating to just and equitable principles of trade and high standards of commercial honor, broker-dealers are required to deal fairly with their customers. While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Moreover, broker-dealers are subject to statutory, Commission and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent. The federal securities laws and rules and SRO rules address broker-dealer conflicts in one of three ways: express prohibition; mitigation; or disclosure.

An important aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the interests of its customer. Broker-dealers also are required under certain circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers, in some cases at the time of the completion of the transaction. The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. At the state level, broker-dealers and their agents must register with or be licensed by the states in which they conduct their business.

Examination and Enforcement Resources

The Commission's Office of Compliance Inspections and Examinations ("OCIE") examines Commission-registered investment advisers using a risk-based approach. Due, among other things, to an increase in the number of Commission-registered advisers, a decrease in the number of OCIE staff, and a greater focus on more complex examinations, the number and frequency of examinations of these advisers by OCIE has decreased in recent years. The Commission recently released a study required by Dodd-Frank Act Section 914 that discusses possible approaches for improving the frequency of investment adviser examinations.

FINRA has primary responsibility for examining broker-dealers. The Commission staff also examines broker-dealers, particularly when a risk has been identified or when evaluating the examination work of an SRO, including FINRA, but generally does not examine broker-dealers on a routine basis. The states are responsible

for examining state-registered investment advisers, and they work with FINRA and the Commission on broker-dealer examinations.

The Commission has broad statutory authority under the federal securities laws to investigate violations of the federal securities laws and SRO rules. The Commission's Division of Enforcement investigates potential securities law violations, recommends that the Commission bring civil actions or institute administrative proceedings, and prosecutes these cases on behalf of the Commission. Examples of enforcement actions involving investment advisers include failures to disclose material conflicts of interest, misrepresentations, and other frauds. For broker-dealers, examples include abusive sales practices, failures to disclose material conflicts of interest, misrepresentations, failures to have a reasonable basis for recommending securities, other frauds, failures to reasonably supervise representatives. The Commission may seek remedial sanctions such as censures, suspensions, injunctions and limitations on business, and violators may be required to pay disgorgement and civil penalties.

Retail Investor Perceptions

Many retail investors and investor advocates submitted comments stating that retail investors do not understand the differences between investment advisers and broker-dealers or the standards of care applicable to broker-dealers and investment advisers. Many find the standards of care confusing, and are uncertain about the meaning of the various titles and designations used by investment advisers and broker-dealers. Many expect that both investment advisers and broker-dealers are obligated to act in the investors' best interests. The Commission has sponsored studies of investor understanding of the roles, duties and obligations of investment advisers and broker-dealers that similarly reflect confusion by retail investors regarding the roles, titles, and legal obligations of investment advisers and broker-dealers, although the studies found that investors generally were satisfied with their financial professionals. Several of the recommendations listed below are designed to address investor confusion and provide for a stronger and more consistent regulatory regime for broker-dealers and investment advisers providing personalized investment advice about securities to retail investors.

Recommendations

Based on its review of the broker-dealer and investment adviser industries, the regulatory landscape, issues raised by commenters, and other considerations required by Dodd-Frank Act Section 913, the Staff prepared recommendations that are listed below. The recommendations are designed to increase investor protection and decrease investor confusion in the most practicable, least burdensome way for investors, broker-dealers and investment advisers.

Uniform Fiduciary Standard: Consistent with Congress's grant of authority in Section 913, the Staff recommends the consideration of rulemakings that would apply expressly and uniformly to both broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, a fiduciary standard

no less stringent than currently applied to investment advisers under Advisers Act Sections 206(1) and (2). In particular, the Staff recommends that the Commission exercise its rulemaking authority under Dodd-Frank Act Section 913(g), which permits the Commission to promulgate rules to provide that:

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

The standard outlined above is referred to in the Study as the "uniform fiduciary standard."

The Staff notes that Section 913 explicitly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities does not, in and of itself, violate the uniform fiduciary standard of conduct applied to a broker-dealer. Section 913 also provides that the uniform fiduciary standard does not necessarily require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice.

The following recommendations suggest a path toward implementing a uniform fiduciary standard for investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers:

- *Standard of Conduct:* The Commission should exercise its rulemaking authority to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

  > the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

Implementing the Uniform Fiduciary Standard: The Commission should engage in rulemaking and/or issue interpretive guidance addressing the components of the uniform fiduciary standard: the duties of loyalty and care. In doing so, the Commission should identify specific examples of potentially relevant and common material conflicts of interest in order to facilitate a smooth transition to the new standard by broker-dealers and consistent interpretations by broker-dealers and investment advisers. The Staff is of the view that the existing guidance and precedent under the Advisers Act regarding

fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply.

- *Duty of Loyalty:* A uniform standard of conduct will obligate both investment advisers and broker-dealers to eliminate or disclose conflicts of interest. The Commission should prohibit certain conflicts and facilitate the provision of uniform, simple and clear disclosures to retail investors about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest.

    - The Commission should consider which disclosures might be provided most effectively (a) in a general relationship guide akin to the new Form ADV Part 2A that advisers deliver at the time of entry into the retail customer relationship, and (b) in more specific disclosures at the time of providing investment advice (e.g., about certain transactions that the Commission believes raise particular customer protection concerns).

    - The Commission also should consider the utility and feasibility of a summary relationship disclosure document containing key information on a firm's services, fees, and conflicts and the scope of its services (e.g., whether its advice and related duties are limited in time or are ongoing).

    - The Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements.

- *Principal Trading*: The Commission should address through interpretive guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.

- *Duty of Care*: The Commission should consider specifying uniform standards for the duty of care owed to retail investors, through rulemaking and/or interpretive guidance. Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor.

- *Personalized Investment Advice About Securities:* The Commission should engage in rulemaking and/or issue interpretive guidance to explain what it means to provide "personalized investment advice about securities."

- *Investor Education:* The Commission should consider additional investor education outreach as an important complement to the uniform fiduciary standard.

The Staff believes that the uniform fiduciary standard and related disclosure requirements may offer several benefits, including the following:

- Heightened investor protection;
- Heightened investor awareness;
- It is flexible and can accommodate different existing business models and fee structures;
- It would preserve investor choice;
- It should not decrease investors' access to existing products or services or service providers;
- Both investment advisers and broker-dealers would continue to be subject to all of their existing duties under applicable law; and
- Most importantly, it would require that investors receive investment advice that is given in their best interest, under a uniform standard, regardless of the regulatory label (broker-dealer or investment adviser) of the professional providing the advice.

The Staff also believes that to fully protect the interests of retail investors, the Commission should couple the fiduciary duty with effective oversight. Dodd-Frank Act Section 913 includes a provision requiring the Commission to enforce violations of the uniform fiduciary standard consistently against investment advisers and broker-dealers. This should provide additional protection to retail investors.

Harmonization of Regulation: The Staff believes that a harmonization of regulation—where such harmonization adds meaningful investor protection—would offer several advantages, including that it would provide retail investors the same or substantially similar protections when obtaining the same or substantially similar services from investment advisers and broker-dealers. The following recommendations address certain other areas where investment adviser and broker-dealer laws and regulations differ, and where the Commission should consider whether laws and regulations that apply to these functions should be harmonized for the benefit of retail investors:

- *Advertising and Other Communications*: The Commission should consider articulating consistent substantive advertising and customer communication rules and/or guidance for broker-dealers and investment advisers regarding the content of advertisements and other customer communications for similar services. In addition, the Commission should consider, at a minimum, harmonizing internal pre-use review requirements for investment adviser and broker-dealer advertisements or requiring investment advisers to designate employees to review and approve advertisements.

- *Use of Finders and Solicitors:* The Commission should review the use of finders and solicitors by investment advisers and broker-dealers and consider whether to provide additional guidance or harmonize existing regulatory requirements to address the status of finders and solicitors and their respective relevant disclosure requirements to assure that retail customers better understand the conflicts associated with the solicitor's and finder's receipt of compensation for sending a retail customer to an adviser or broker-dealer.

- *Supervision:* The Commission should review supervisory requirements for investment advisers and broker-dealers, with a focus on whether any harmonization would facilitate the examination and oversight of these entities (e.g., whether detailed supervisory structures would not be appropriate for a firm with a small number of employees) and consider whether to provide any additional guidance or engage in rulemaking.

- *Licensing and Registration of Firms:* The Commission should consider whether the disclosure requirements in Form ADV and Form BD should be harmonized where they address similar issues, so that regulators and retail investors have access to comparable information. The Commission also should consider whether investment advisers should be subject to a substantive review prior to registration.

- *Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers:* The Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.

- *Books and Records:* The Commission should consider whether to modify the Advisers Act books and records requirements, including by adding a general requirement to retain all communications and agreements (including electronic information and communications and agreements) related to an adviser's "business as such," consistent with the standard applicable to broker-dealers.

The Staff understands and is sensitive to the fact that, in addition to the benefits they would provide, changes in legal or regulatory standards related to providing personalized investment advice to retail investors could lead to increased costs for investors, investment advisers, broker-dealers, and their associated persons. The Study considers a number of potential costs, expenses and impacts of various potential regulatory changes.

Dodd-Frank Act Section 913 required the Staff to consider the potential impact of: (a) eliminating the broker-dealer exclusion from the definition of "investment adviser" in the Advisers Act; and (b) applying the duty of care and other requirements of the Advisers Act to broker-dealers. The Staff believes that these alternatives would not provide the Commission with a flexible, practical approach to addressing what standard

should apply to broker-dealers and investment advisers when they are performing the same functions for retail investors.

* * *

In the end, the Staff's recommendations were guided by an effort to establish a standard to provide for the integrity of advice given to retail investors and to recommend a harmonized regulatory regime for investment advisers and broker-dealers when providing the same or substantially similar services, to better protect retail investors. The Staff developed its recommendations with a view toward minimizing cost and disruption and assuring that retail investors continue to have access to various investment products and choice among compensation schemes to pay for advice.

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I. Introduction

A. Study's Mandate

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[1] Dodd-Frank Act of Title IX of Section 913 ("Dodd-Frank Section 913") requires the Commission to conduct a study regarding the obligations of brokers, dealers, and investment advisers ("Study").

Specifically, Dodd-Frank Act Section 913(b) requires the evaluation of the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with brokers, dealers, and investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association (i.e., the Financial Industry Regulatory Authority ("FINRA")), and other Federal and State legal or regulatory standards. In addition, the Study must evaluate whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, and persons associated with brokers, dealers, and investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute. Dodd-Frank Act Section 913(g) defines a "retail customer" as "a natural person, or the legal representative of a natural person, who – (A) receives personalized investment advice about securities from a broker, dealer, or investment adviser, and (B) uses such advice primarily for personal, family or household purposes."

Dodd-Frank Act Section 913(c) specifies 14 issues that the Commission must consider in conducting the Study. These issues are:

- The effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards;

- Whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute;

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

- Whether retail customers understand that there are different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers in the provision of personalized investment advice about securities to retail customers;

- Whether the existence of different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers is a source of confusion for retail customers regarding the quality of personalized investment advice that retail customers receive;

- The regulatory, examination, and enforcement resources devoted to, and activities of, the Commission, the States, and a national securities association to enforce the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers when providing personalized investment advice and recommendations about securities to retail customers, including—

    (A) the effectiveness of the examinations of brokers, dealers, and investment advisers in determining compliance with regulations;

    (B) the frequency of the examinations; and

    (C) the length of time of the examinations;

- The substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers;

- The specific instances related to the provision of personalized investment advice about securities in which—

    (A) the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of brokers and dealers; and

    (B) the regulation and oversight of brokers and dealers provide greater protection to retail customers than the regulation and oversight of investment advisers;

- The existing legal or regulatory standards of state securities regulators and other regulators intended to protect retail customers;

- The potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers, and persons associated with brokers or

dealers—

(A) the standard of care applied under the Investment Advisers Act of 1940 ("Advisers Act") for providing personalized investment advice about securities to retail customers of investment advisers, as interpreted by the Commission and the courts; and

(B) other requirements of the Advisers Act;

- The potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" under Advisers Act Section 202(a)(11)(C), in terms of—

  (A) the impact and potential benefits and harm to retail customers that could result from such a change, including any potential impact on access to personalized investment advice and recommendations about securities to retail customers or the availability of such advice and recommendations;

  (B) the number of additional entities and individuals that would be required to register under, or become subject to, the Advisers Act, and the additional requirements to which brokers, dealers, and persons associated with brokers and dealers would become subject, including—

    (i) any potential additional associated person licensing, registration, and examination requirements; and

    (ii) the additional costs, if any, to the additional entities and individuals; and

  (C) the impact on Commission and State resources to—

    (i) conduct examinations of registered investment advisers and the representatives of registered investment advisers, including the impact on the examination cycle; and

    (ii) enforce the standard of care and other applicable requirements imposed under the Advisers Act;

- The varying level of services provided by brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers to retail customers and the varying scope and terms of retail customer relationships of brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers with such retail customers;

- The potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations to retail customers regarding the provision of investment advice, including any potential impact on—

    (A) protection from fraud;

    (B) access to personalized investment advice, and recommendations about securities to retail customers; or

    (C) the availability of such advice and recommendations;

- The potential additional costs and expenses to—

    (A) retail customers regarding, and the potential impact on the profitability of, their investment decisions; and

    (B) brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations, including duty of care, to retail customers; and

- Any other considerations that the Commission considers necessary and appropriate in determining whether to conduct a rulemaking, following the study, to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers.

These considerations are addressed in more detail in the relevant portions of the Study below. Finally, the Commission is required by Dodd-Frank Act Section 913(d) to submit a report on the Study to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee of Financial Services of the House of Representatives. The report must describe the findings, conclusions and recommendations from the Study. The views expressed in this Study are those of the Staff and do not necessarily reflect the views of the Commission or the individual Commissioners.

B. Study's Scope

Dodd-Frank Act Section 913(e) directs the Commission to seek and consider public input in preparing the Study. On July 27, 2010, the Commission published a request for

public comments and data to inform the Study.[2] The comment period closed on August 30, 2010. The Commission received more than 3,000 individualized comments, including comments from investors, financial professionals, industry groups, academics, and other regulators. The Commission also received over 500 comments that comprised seven types of form letters. The Commission staff has carefully considered the views of these commenters and has incorporated them in the Study, as appropriate.

Given the array of issues to be considered in the Study, including issues related to investment advisers, broker-dealers, investor disclosures, costs, and examination and enforcement responsibilities and resources, a cross-Divisional staff task force was formed to bring a multi-disciplinary approach to the Study ("Staff"). Staff participants include representatives from the:

Division of Investment Management;
Division of Risk, Strategy, and Financial Innovation;
Division of Trading and Markets;
Office of Compliance Inspections and Examinations;
Office of the General Counsel; and
Office of Investor Education and Advocacy.

To help further inform the Study and consistent with the Commission's public outreach on these issues, the Staff met with interested parties representing a variety of perspectives beginning in August 2010 (see Appendix B). The Staff met with outside groups constituting a range of industry perspectives, from wirehouses to financial planners. In addition, the Staff met with FINRA, state securities regulators (i.e., the North American Securities Administrator Association ("NASAA")), and organizations (e.g., the Consumer Federation of America, the Committee for a Fiduciary Standard and the Public Investors Arbitration Bar Association). The Staff also requested assistance from state securities regulators and FINRA with the aspects of the study involving their efforts, such as examinations and enforcement.

II. Overview of the Current Business and Regulatory Landscape

Investment advisers and broker-dealers offer a variety of services and products to their retail clients and customers, with the scope and terms of the relationship and the associated compensation reflecting the services and products offered. The following section summarizes the size and scope of the investment advisory and brokerage businesses, including dual registrants, focusing particularly on the various services and products provided by investment advisers and broker-dealers to retail clients and customers, and the scope and terms of advisory or brokerage relationships with retail clients and customers.

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[2] Study Regarding Obligations of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 62577 (July 27, 2010).

A. Current Business Landscape for Investment Advisers and Broker-Dealers

1. Investment Advisers

Investment advisers provide a wide range of investment advisory services and play an important role in helping individuals and institutions make significant financial decisions. From individuals and families seeking to plan for retirement or save for college to large institutions managing billions of dollars, clients seek the services of investment advisers to help them evaluate their investment needs, plan for their future, develop and implement investment strategies, and cope with the ever-growing complexities of the financial markets. Today, the more than 11,000 advisers registered with the Commission manage more than $38 trillion for more than 14 million individual and institutional clients.[3] In addition, there are more than 275,000 investment adviser representatives registered in the applicable states and more than 15,000 state-registered investment advisers.[4]

The majority of Commission-registered investment advisers manage client portfolios.[5] For example, approximately 75% of Commission-registered investment

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[3] Unless otherwise specified, the statistics in Section II.A.1 are based on data derived from Commission-registered investment advisers' responses to questions on Part 1A of Form ADV reported through the Investment Adviser Registration Depository ("IARD") as of September 30, 2010. This does not include state-registered investment advisers. We note that these figures will change due to the reallocation of federal and state responsibilities for registered investment advisers provided by Title IV of the Dodd-Frank Act. See, e.g., Study on Enhancing Investment Adviser Examinations (Jan. 2011) (the "Section 914 Study"). See also Commissioner Elisse B. Walter, Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 2010) , available at http://www.sec.gov/news/speech/2011/spch011911ebw.pdf ("Commissioner Walter Statement"). See also Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110 (Nov. 19, 2010) ("Release 3110"). The number of investment advisers has increased by 38.5% since 2004, when there were 8,581 registered investment advisers; and the amount of assets under management of registered investment advisers also has increased, by 58.9% since 2004, when assets totaled $24.1 trillion. Section 914 Study at 8 – 9.

[4] See Sections II.C.1 and II.C.2 of the Study, infra, for a discussion of the federal and state registration requirements for investment advisers and investment adviser representatives.

[5] Form ADV (Uniform Application for Investment Adviser Registration) requires applicants to, among other things, identify the types of clients and advisory service provided. The types of clients listed in Part 1A, Item 5.D of Form ADV are individuals (other than high net worth individuals); high net worth individuals (as that term is defined in the Glossary to Form ADV); banking or thrift institutions; investment companies (including mutual funds); pension and profit sharing plans (other than plan participants); other pooled investment vehicles (e.g., hedge funds); charitable organizations; corporations or other businesses not previously listed; state or municipal government entities; and any other type of clients. The ten types of advisory activities listed in Part 1A, Item 5.G of Form ADV include financial planning services; portfolio management for individuals and/or small businesses; portfolio management for investment companies; portfolio management for business or institutional clients (other than investment companies); pension

advisers managed the portfolios of individuals and small businesses. Commission-registered investment advisers also reported that approximately 91.2% of their assets under management were in discretionary accounts, while 8.8% were in non-discretionary accounts.[6] Approximately 63.9% of Commission-registered investment advisers reported that 51% or more of their assets under management related to the accounts of individual clients (other than high net worth individuals).

Investment advisers also manage the portfolios of pooled investment vehicles such as hedge funds and other private funds, pension funds and registered investment companies. Investment advisers also provide financial planning and pension consulting services, or may select investment advisers for others. In addition, investment advisers sponsor wrap fee programs and may act as portfolio managers in wrap fee programs.[7] Some investment advisers publish periodicals or newsletters, or provide securities ratings or pricing services. Many investment advisers also engage in other non-advisory businesses, such as insurance broker or agent, or as a registered broker-dealer or registered representative of a broker-dealer.[8] Most investment advisers charge clients fees for investment advisory services based on the percentage of assets under management (over 95%).[9] Others may charge hourly or fixed rates. Few investment advisers reported receiving commission-based compensation (8.9% of Commission-registered investment advisers). The majority of Commission-registered investment advisers (51.2%) reported that they have six or fewer non-clerical employees, and 91% reported that they have 50 or fewer employees.

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consulting services; selection of other advisers; publication of periodicals or newsletters; security ratings or pricing services; market timing services; and any other advisory service.

6 These figures do not distinguish between the types of clients (i.e., individual or institutional).

7 Form ADV's Glossary defines a "wrap fee program" as "any advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of client transactions." Part 1A, Item 5.I of Form ADV requires applicants to identify whether they participate in a wrap fee program, and if so, whether they sponsor the program or act as a portfolio manager to the program.

8 Part 1A, Item 6 of Form ADV requires an investment adviser applicant to disclose, among other things, whether it is actively engaged in business as a broker-dealer; registered representative of a broker-dealer; futures commission merchant, commodity pool operator, or commodity trading advisor; real estate broker, dealer, or agent; insurance broker or agent; bank (including a separately identifiable department or division of a bank); other financial product salesperson; or any other business (other than giving investment advice).

9 Part 1A, Item 5.E of Form ADV requires applicants to disclose whether they are compensated for their investment advisory services by a percentage of assets under management; hourly charges; subscription fees (for a newsletter or periodical); fixed fees (other than subscription fees); commissions; performance-based fees; or any other fees.

2. Broker-Dealers

Like investment advisers, broker-dealers provide services that play an important role in helping retail and institutional investors make significant financial decisions. As intermediaries, they connect investors to investments, which range from common stock and mutual funds to complex financial products, and in doing so, enhance the overall liquidity and efficiency of the financial markets. As of the end of 2009, broker-dealers held approximately 110 million customer accounts.[10] Currently, the Commission oversees approximately 5,100 broker-dealers[11] with over 600,000 registered representatives[12] engaging in a variety of business activities, which may or may not include the provision of personalized investment advice or recommendations about securities to retail customers.[13] Of the 5,100 registered broker-dealer firms, 985 have indicated on Form BD that they engage in, or expect to engage in, investment advisory services constituting one percent or more of their annual revenue.[14]

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10 See letter from Angela Goelzer, FINRA, dated Jan. 11, 2011 ("FINRA January Letter") (noting that as of December 31, 2009, there were 109.5 million retail and institutional accounts held at FINRA registered broker-dealers).

11 Unless otherwise specified, the statistics in Section II.A.2 are based on data derived from broker-dealers' responses to questions on the Uniform Application for Broker-Dealer Registration ("Form BD") reported through the Central Registration Depository ("CRD") as of September 30, 2010. Of this number, approximately 4,600 are FINRA member firms with approximately 163,000 branch offices. FINRA Statistics, available at http://www.finra.org/Newsroom/Statistics.

12 These figures are based on data derived from the BrokerCheck system as of September 30, 2010. See also FINRA, 2009 Annual Financial Report, at 2, available at: http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p122204.pdf. The number of FINRA member firms has decreased by 10.4% since 2005, from 5,111 to 4,578 in 2010. The number of registered representatives has decreased by 3.8% since 2005, from 655,832 to 630,692 in 2010. FINRA Statistics, available at http://www.finra.org/Newsroom/Statistics/, and NASD 2005 Year in Review at 7, available at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p016705.pdf .

13 Form BD requires applicants to identify the types of business engaged in (or to be engaged in) that accounts for 1% or more of the applicant's annual revenue from the securities or investment advisory business. The 29 types of business listed on Form BD include, among others: engaging in stock exchange floor activities; making inter-dealer markets in corporate securities over-the-counter; retailing corporate equity securities over-the-counter; acting as an underwriter or selling group participant; acting as a mutual fund underwriter or sponsor; retailing mutual funds; acting as a U.S. government securities dealer or broker; acting as a municipal securities dealer or broker; selling variable life insurance or annuities; selling securities of only one issuer or associate issuers (other than mutual funds); providing investment advisory services; trading securities for own account; engaging in private placements of securities; and any other business.

14 These figures are based on data derived from broker-dealers' responses to questions on Form BD reported through the CRD as of September 30, 2010. Form BD does not define "investment advisory business." Rather, it is up to the applicant to determine and disclose. "Investment advisory business" could be any investment advisory activity, regardless of whether it requires registration as an adviser (at the federal or state level), that amounts to 1% or more of the applicant's annual revenue. According to FINRA, as of September 30, 2010, 1,734 or approximately 37%, of its 4,648 registered firms had affiliates that engaged in investment advisory

The products and services offered by broker-dealers fall into two broad categories: brokerage services and dealer services. Generally, a broker is one who acts as an agent for someone else, while a dealer is one who acts as principal for its own account.[15] A person can act as principal by selling securities out of inventory, or act in a riskless principal capacity.[16] A person can be both a broker and a dealer.

Broker-dealers may offer a variety of brokerage (i.e., agency) services and products to retail customers including, but not limited to: providing execution-only services (e.g., discount brokerage);[17] providing custody and trade execution to a customer who has selected an independent financial adviser; executing trades placed by investment advisers in a wrap fee programs; offering margin accounts; providing generalized research, advice, and education; [18] operating a call center (e.g., responding to a customer request for stock quotes, information about an issuer or industry, and then placing a trade at the customer's request);[19] providing asset allocation services with recommendations about asset classes, specific sectors, or specific securities; providing customer-specific research and analysis; [20]

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activities. Of these 1,734 firms, approximately 83% were not dually registered as investment advisers, and approximately 17% were dually registered. In addition to the 1,734 firms, there were 553 firms that were dually registered but did not report having an investment advisory affiliate. FINRA January Letter, supra note 10.

15 See discussion in Section II.B below.

16 A riskless principal transaction is generally defined as one in which a broker or dealer, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security to offset a contemporaneous sale to (or purchase from) the customer. See Exchange Act Rule 10b-10(a)(2)(ii).

17 See, e.g., letter from R. Scott Henderson, Deputy General Counsel, Global Wealth & Investment Management, Bank of America, dated Aug. 30, 2010 ("BOA Letter"); letter from David M. Carroll, Senior Executive Vice President of Wealth, Brokerage and Retirement, Wells Fargo & Co., dated Aug. 30, 2010 ("Wells Fargo Letter").

18 Examples of generalized research, advice and education include: issuing sell-side research reports; providing third-party or proprietary securities research to a customer (e.g., online research pages or "electronic libraries" of research, reports, news, quotes, and charts that customers can obtain or request); providing self-directed tools to allow customers to sort through a broad range of stocks and industry sectors; and providing subscription services to e-mails or other communications that alert customers to news affecting the securities in the customers' portfolios or on the customers' "watch list." See, e.g., NASD Notice to Members 01-23 (Suitability Rule and Online Communications).

19 See, e.g., letter from Christopher P. Gilkerson, Senior Vice President & Deputy General Counsel, Charles Schwab & Co., Inc., dated Aug. 30, 2010 ("Schwab Letter").

20 Examples of customer-specific research and analysis include: sending customer-specific electronic communications to a targeted customer or targeted group of customers encouraging the particular customer(s) to buy a security; sending customers an e-mail stating that customers should invest in a particular sector and providing a list of "buy" or "sell" recommendations; and providing a portfolio analysis tool that generates buy or sell recommendations of specific securities. See, e.g., NASD Notice to Members 01-23 (Suitability Rule and Online Communications).

exercising limited trading discretion over customer accounts;[21] providing transaction-specific recommendations to buy or sell securities in a non-discretionary account for commissions;[22] providing discretionary portfolio management for commissions; providing financial planning for commissions or no fee; [23] and providing comprehensive (or private) wealth management for commissions.[24]

Broker-dealers also may offer a variety of dealer (i.e., principal) services and products to retail customers, including, but not limited to: selling securities (such as bonds) out of inventory; buying securities from customers; selling proprietary products (e.g., products such as affiliated mutual funds, structured products, private equity and other alternative investments); selling initial and follow-on public offerings; selling other underwritten offerings; acting as principal in Individual Retirement Accounts; acting as a market maker; and otherwise acting as a dealer.[25] Broker-dealers may offer solely proprietary products, a limited range of products, or a diverse range of products.[26]

In addition to these broker and dealer activities, broker-dealers often provide ancillary services, such as lending, bill paying, cash sweeps, and debit cards.[27] Broker-dealers may also refer investors to affiliates for non-securities related financial offerings, such as mortgages, insurance, credit cards or bank deposits.[28]

Broker-dealers currently offer customers a variety of pricing and compensation structures for the products and services offered.[29] Generally, the compensation in a broker-

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21 See, e.g., letter from Sarah A. Miller, Senior Vice President, American Bankers Association ("ABA"), and Executive Director and General Counsel, ABA Securities Association ("ABASA"), dated Aug. 30, 2010 ("ABA & ABASA Letter").

22 See, e.g., Schwab Letter, supra note 19.

23 Id.

24 Examples of comprehensive (or private) wealth management include: life event planning; retirement planning; college planning; tax management; life insurance; estate planning; and charitable giving.

25 See Guide to Broker-Dealer Registration, (April 2008), available at: http://www.sec.gov/divisions/marketreg/bdguide.html ("Guide to Broker-Dealer Registration"); BOA Letter, supra note 17; letter from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, dated Aug. 30, 2010 ("SIFMA Letter"); Wells Fargo Letter, supra note 17.

26 See, e.g., letter from Michael Koffler and Clifford E. Kirsch, Sutherland, Asbill & Brennan LLP, on behalf of the Committee of Annuity Insurers, dated Aug. 30, 2010 ("CAI Letter").

27 See, e.g., SIFMA Letter, supra note 25; BOA Letter, supra note 17.

28 See, e.g., Wells Fargo Letter, supra note 17.

29 See, e.g., BOA Letter, supra note 17; SIFMA Letter, supra note 25.

dealer relationship is transaction-based and is earned through commissions, mark-ups, mark-downs, sales loads or similar fees on specific transactions, where advice is provided that is solely incidental to the transaction.[30] A brokerage relationship may involve incidental advice with transaction-based compensation, or no advice and, therefore no charge, for advice.[31]

As noted above, this wide spectrum of services and products provided by broker-dealers may or may not involve the provision of personalized investment advice or recommendations about securities to retail customers.[32] Moreover, there are variations in the level and the extent of the advice and recommendations provided and the compensation structure that applies.[33]

Broker-dealers provide brokerage products and services to a broad range of retail customers. For example, retail customers may include inexperienced retail investors seeking more basic brokerage services and recommendations, as well as retail investors with aggressive investment objectives or unique situations that are seeking sophisticated investment strategies (e.g., concentrated positions, hedging, options, and other complex strategies).[34] Retail customers may have multiple relationships and accounts with the same broker-dealer, with varying levels of service provided to each account.[35] For example, a retail customer may have a brokerage account that includes the provision of investment advice and recommendations for commissions, and also a self-directed brokerage account that does not include such advice or recommendations, with a single broker-dealer.[36]

Most broker-dealers are small in size. As of the end of December 2010, approximately 53% of all FINRA-registered broker-dealers employ 10 or fewer registered individuals (i.e., registered representatives or registered principals).[37] Approximately 29% of FINRA-registered broker-dealers employ 10-50 registered individuals, approximately

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30 See, e.g., letter from John Ivan, Senior Vice President and General Counsel, Janney Montgomery Scott, dated Aug. 30, 2010 ("Janney Letter"); Schwab Letter, supra note 19; SIFMA Letter, supra note 25.

31 See, e.g., Wells Fargo Letter, supra note 17.

32 As addressed in more detail in Section IV.C.3, commenters provided a variety of views on which broker-dealer services and products involved personalized investment advice or recommendations for retail customers, and the extent to which a new standard of conduct should apply to such products.

33 See, e.g., Schwab Letter, supra note 19.

34 See, e.g., SIFMA Letter, supra note 25; BOA Letter, supra note 17.

35 See, e.g., ABA & ABASA Letter, supra note 21.

36 See, e.g., ABA & ABASA Letter, supra note 21.

37 See FINRA January Letter, supra note 10.

9% employ 51-150 registered individuals, and the remaining 9% employ over 151 registered individuals.[38]

3. Dual Registrants

As indicated above, many financial services firms may offer both investment advisory and broker-dealer services.[39] For example, approximately 5% of Commission-registered investment advisers reported that they also were registered as a broker-dealer, and 22% of Commission-registered investment advisers reported that they had a related person that was a broker-dealer.[40] In addition, as of mid-October 2010, 842 firms registered with FINRA as a broker-dealer, or approximately 18% of broker-dealers registered with FINRA, were also registered as an investment adviser with either the Commission or a state.[41] Further, as of the end of September 2010, approximately 37% of FINRA-registered broker-dealers had an affiliate engaged in investment advisory activities.[42]

Many of these financial services firms' personnel may also be dually registered as investment adviser representatives and registered representatives. As of mid-October 2010, approximately 88% of investment adviser representatives were also registered representatives of a FINRA registered broker-dealer.[43]

Dual registration often allows these firms to provide a variety of services not available through entities that are solely registered as investment advisers or broker-dealers. For example, one firm noted that dual registrants may "provide under one roof a combination of immediate execution, liquidity, research-driven guidance, a wide choice of products, securities tailored to individual client needs, and other services" that go beyond what non-dually registered investment advisers and broker-dealers offer.[44]

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38 See FINRA January Letter, supra note 10.

39 See, e.g., Schwab Letter, supra note 19; SIFMA Letter, supra note 25; BOA Letter, supra note 17; letter from John Junek, Executive VP and General Counsel, Ameriprise Financial, Inc., dated Aug. 30, 2010 ("Ameriprise Letter"); Robert J. McCann, CEO, UBS Financial Services, Inc., dated Aug. 30, 2010 ("UBS Letter"); and letter from Charles D. Johnston, President, Morgan Stanley Smith Barney LLC, dated Aug. 30, 2010 ("Morgan Stanley Letter").

40 See Section 914 Study and Commissioner Walter Statement, supra note 3.

41 See letter from Angela C. Goelzer, FINRA, dated Nov. 3, 2010 ("FINRA November Letter"). As of September 30, 2010, 856 firms overseen by FINRA were dually registered. See FINRA January Letter, supra note 10.

42 See FINRA January Letter, supra note 10. Of these firms, approximately 83% were not dually registered as investment advisers, and approximately 17% were dually registered. In addition to the 1,734 firms, there were 553 firms that were dually registered but did not report having an investment advisory affiliate. FINRA January Letter, supra note 10.

43 FINRA November Letter, supra note 41.

44 See, e.g., UBS Letter, supra note 39.

A number of large financial service firms noted that some of their clients and customers maintained multiple types of accounts and relationships with them, such as a self-directed brokerage account, a brokerage account in which personalized advice is provided, and a fee-based investment advisory account.[45] Firms report that retail investors maintain these multiple accounts for a number of reasons, including: (1) using the brokerage account to hold concentrated positions (such as the stock of their employer) or other securities (e.g., municipal or corporate bonds) for which they do not want ongoing investment advice or for which they do not want to pay an ongoing, asset-based fee (because, for example, they intend to buy and hold the security); (2) using the brokerage account to access products and services offered by a firm on a principal basis, including proprietary products;[46] or (3) taking advantage of the differing forms of compensation paid for maintaining a brokerage or an advisory account.[47] Therefore, retail investors may have a portfolio consisting of multiple accounts subject to investment adviser or broker-dealer regulation, and they may receive advice from "dual-hatted" personnel that are also subject to investment adviser and broker-dealer regulation. While these multiple accounts may, depending on the circumstances, benefit investors, they also can present conflicts that need to be managed by the dual registrants.[48]

B. Commission and Self Regulatory Organization ("SRO") Regulation of Investment Advisers and Broker-Dealers

Investment advisers and broker-dealers must adhere to high standards of conduct in their interactions with investors. These standards of conduct are imposed by the federal securities laws and, in the case of broker-dealers, also by SRO rules. The following section provides an overview of the existing legal and regulatory framework developed by the Commission, SRO, state and other regulation to govern the activities of investment advisers and broker-dealers, especially when they provide personalized investment advice and recommendations about securities to retail investors. This section discusses, among other things, regulations applicable to investment advisers and broker-dealers when they provide personalized investment advice about securities, including, but not limited to, duty of fair dealing, fiduciary duty, ethical standards of conduct, suitability, disclosure obligations, principal trading, and advertising. It also discusses additional topics such as recordkeeping, supervision and compliance, and investor remedies.

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45 See, e.g., BOA Letter, supra note 17 ("It is not uncommon for clients to decide that they want some of their assets to be guided by advice and to self-direct other assets, and to maintain two or more accounts with the same financial services provider. More specifically, a client may want to maintain a discretionary investment advisory account, a brokerage account in which investment advice is provided, and a brokerage account for unsolicited trade executions."); Schwab Letter, supra note 19 (noting that the majority of households that have one account enrolled in a fee-based advisory program also have a self-directed brokerage account at Schwab).

46 See, e.g., Morgan Stanley Letter, supra note 39.

47 See, e.g., UBS Letter, supra note 39.

48 See, e.g., In the Matter of Valentine Capital Asset Management, Inc., Investment Advisers Act Release No. 3090 (Sept. 29, 2010) (settled order) ("Release 3090").

In addition to this section, Appendix A discusses the effectiveness of the regulatory, examination, and enforcement resources of the Commission, FINRA, and the states devoted to enforcing the standards of care for investment advisers and broker-dealers when providing personalized investment advice about securities to retail investors. In particular, this appendix discusses the effectiveness of the examinations of broker-dealers and investment advisers in determining compliance with regulations, including ongoing efforts and recent initiatives by OCIE, FINRA, and the states. It also provides data about the frequency and length of investment adviser and broker-dealer examinations, and discusses the typical outcomes resulting from examinations, such as deficiency letters and referrals to the Division of Enforcement, FINRA, or the states, as appropriate. The appendix also discusses the enforcement resources and programs of the Commission, FINRA, and the states, and provides examples of recent initiatives and ongoing efforts designed to enforce the standards of care.

The following discussion is intended to provide a general overview of certain significant federal and SRO requirements and standards of conduct applicable to investment advisers and broker-dealers, and does not address every aspect of investment adviser or broker-dealer regulation. Accordingly, this overview is not meant to serve and should not be interpreted as a comprehensive treatise on the regulation of investment advisers and broker-dealers. It also does not create any new, or supersede any existing, positions of the Commission or the Commission staff.

1. Investment Advisers

a) Overview of Commission Regulation

The Advisers Act is the last in a series of federal statutes intended to eliminate abuses in the securities industry that Congress believed contributed to the stock market crash of 1929 and the Depression of the 1930s. The Advisers Act resulted from a comprehensive congressionally-mandated study conducted by the Commission of investment companies, investment counsel, and investment advisory services. Ultimately, the report concluded that the activities of investment advisers and advisory services "patently present various problems which usually accompany the handling of large liquid funds of the public."[49] The Commission's report stressed the need to improve the professionalism of the industry, both by eliminating tipsters and other scam artists and by emphasizing the importance of unbiased advice, which spokespersons for investment counsel saw as distinguishing their profession from investment bankers and brokers.[50] The general objective "was to protect the public and investors against malpractices by persons paid for advising others about securities."[51]

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49 H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939).

50 See Investment Trusts and Investment Companies: Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477 at 27-30 (1939).

51 S. Rep. No. 1760, 86th Cong., 2d Sess. 1 (1960).

Many money managers, investment consultants, and financial planners are regulated as "investment advisers" under the Advisers Act or similar state statutes. Investment adviser employees that provide personalized investment advice are regulated as "investment adviser representatives" under state statutes and are also subject to supervision by the investment adviser, as discussed below.[52]

Advisers Act Section 202(a)(11) defines "investment adviser" to mean:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

As a general matter, a person would be an investment adviser within the meaning of the Advisers Act if that person:

(1) Provides advice, or issues reports or analyses, regarding securities;

(2) Is in the business of providing such services; and

(3) Provides such services for compensation.[53]

The staff has interpreted each of these elements broadly.[54]

The Advisers Act excludes, among other service providers, certain brokers and dealers, and banks and bank holding companies (except if the bank or bank holding company advises a registered investment company) from the definition of investment adviser, even though the service provider may satisfy all three elements of the definition.[55] A person excluded from the definition of investment adviser is not subject to any provisions of the Advisers Act. We focus here on the exclusion available to brokers and dealers.

The Advisers Act excludes from the investment adviser definition any broker or dealer: (i) whose performance of its investment advisory services is "solely incidental" to

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52 In general, states that register and regulate investment adviser representatives require that the representatives register on Form U4 and pay a fee. See Section II.C.1, infra.

53 See Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) ("Release 1092").

54 Id.

55 See Advisers Act Section 202(a)(11)(A)-(G) for a list of those excluded from the definition of investment adviser.

the conduct of its business as a broker or dealer; and (ii) who receives no "special compensation" for its advisory services. To rely on the exclusion, a broker-dealer must satisfy both of these elements.[56]

Generally, the "solely incidental" element amounts to a recognition that broker-dealers commonly give a certain amount of advice to their customers in the course of their regular business as broker-dealers and that "it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business."[57] On the other hand, "special compensation" "amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendering of advice should be considered an investment adviser and not be excluded from the purview of the [Advisers] Act merely because he is also engaged in effecting market transactions in securities."[58] Finally, the Commission staff has taken the position that a registered representative of a broker-dealer is entitled to rely on the broker-dealer exclusion if he or she is providing investment advisory services to a customer within the scope of his or her employment with the broker-dealer.[59]

Registration

Generally, a person or firm that falls within the definition of "investment adviser" (and is not eligible to rely on one of the exclusions) must register under the Advisers Act, unless it: (i) qualifies to rely on an exemption from the Advisers Act's registration requirement;[60] or (ii) is prohibited from registering under the Advisers Act, as discussed

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56 See Advisers Act Section 202(a)(11)(C). In 2005, the Commission adopted Advisers Act Rule 202(a)(11)-1, the principal purpose of which was to deem broker-dealers offering "fee-based brokerage accounts" as not being subject to the Advisers Act. See Certain Broker-Dealers Deemed Not to be Investment Advisers, Investment Advisers Act Release No. 2376 (Apr. 12, 2005) ("Release 2376"). Fee-based brokerage accounts are similar to traditional full-service brokerage accounts, which provide a package of services, including execution, incidental investment advice, and custody. The primary difference between the two types of accounts is that a customer in a fee-based brokerage account pays a fee based upon the amount of assets on account (an asset-based fee), whereas a customer in a traditional full-service brokerage account pays a commission (or a mark-up or mark-down) for each transaction.

On March 30, 2007, the U.S. Court of Appeals for the District of Columbia Circuit (the "Court"), in Financial Planning Association v. SEC, 482 F.3d 481 (D.C. Cir. 2007), vacated the original Advisers Act Rule 202(a)(11)-1 on the grounds that the Commission did not have the authority to exclude broker-dealers offering fee-based brokerage accounts from the definition of "investment adviser."

57 Opinion of the General Counsel Relating to Section 202(a)(11)(C) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 2 (Oct. 28, 1940).

58 Id.

59 See Release 1092, supra note 53.

60 See Advisers Act Sections 203(b), 203(l) and 203(m). The registration exemptions include, for example, foreign private advisers, venture capital fund advisers, private fund advisers with less than $150 million in assets under management in the United States, advisers to small business

immediately below. An unregistered investment adviser is subject to the Advisers Act's antifraud provisions but is not subject to most of the other requirements of the Advisers Act.[61]

Advisers Act Section 203A *prohibits* investment advisers with less than $25 million of assets under management from registering under the Advisers Act[62] (the Dodd-Frank Act raised this amount to $100 million as of July 21, 2011)[63] if they are required to be regulated in a state or states in which they maintain a principal office and place of business (the Dodd-Frank Act amended Section 203A to provide that investment advisers must also be subject to inspection and examination by their home state).[64]

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investment companies, intrastate advisers, advisers to insurance companies, charitable organizations and plans and certain commodity trading advisors. Note that some of these exemptions recently were added as part of the Dodd-Frank Act (i.e., Dodd-Frank Act Section 403 (relating to private fund and foreign advisers and certain intrastate advisers) and Dodd-Frank Act Section 407 (relating to venture capital advisers). See also Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111 (Nov. 19, 2010).

61 See, e.g., S. Rep. No. 1760, 86th Cong., 2d Sess. 7 (1960), which specifies that the antifraud provisions in Section 206 apply to registered and unregistered investment advisers.

62 "Assets under management" is defined in Advisers Act Section 203A(a)(2) as the securities portfolios for which the adviser provides continuous and regular supervision or management services. See also Instructions to Item 5b of Form ADV, Part 1A.

63 See Dodd-Frank Act Section 410 and Advisers Act Section 203A. See Release 3110, supra note 3.

64 Advisers Act Section 203A was added by the National Securities Markets Improvement Act of 1996 ("NSMIA"). A state may not require an investment adviser to register if the adviser (i) does not have a place of business in the state and (ii) has fewer than six clients who are state residents during the past twelve months. See Advisers Act Section 222(d). Advisers Act Section 203A(b)(1) also prohibits a state from imposing registration or licensing requirements on an investment adviser that is excluded from the definition of investment adviser by Section 202(a)(11). Currently, Wyoming does not have a statutory requirement for investment adviser registration.

There are several exceptions to this general prohibition. See Advisers Act Section 203A. For example, investment advisers to registered investment companies must always register with the Commission, regardless of asset size. Other advisers that may register voluntarily under the Advisers Act include: pension consultants that provide services to pension funds with over $50 million in assets; newly formed advisers that expect to qualify for registration under the Advisers Act within 120 days of registration; certain affiliated advisers that are in a control relationship with a registered adviser, provided that they have the same principal office and place of business; certain internet advisers; and multi-state advisers that would otherwise be regulated by at least 30 states (the Dodd-Frank Act amends this to 15 states for mid-sized advisers as of July 21, 2011, and the Commission has proposed a similar amendment to Advisers Act Rule 203A-2). See also Advisers Act Rule 203A-2. See also Release 3110, supra note 63.

The Registration Process: Form ADV

Advisers use Form ADV to apply for registration with the Commission (Part 1A) or with state securities authorities (Part 1B), and must keep Form ADV current by filing periodic amendments as long as they are registered.[65] Form ADV has two parts (Part 1 and Part 2) and is filed electronically through the IARD;[66] each part (except for the brochure supplement, as discussed below) is available to investors on the Investment Adviser Public Disclosure website ("IAPD").[67]

Part 1 (A and B) of Form ADV provides federal and state regulators with information to process registrations and to manage their regulatory and examination programs. It requires applicants to disclose information about their disciplinary history, type of services provided and other aspects of their business.[68] An investment adviser must update Part 1 of its Form ADV at least annually (within 90 days of their fiscal year end), or more often under certain circumstances (e.g., certain disciplinary actions or changes to an adviser's services or contact information).[69]

The Commission recently amended Part 2 substantially.[70] Part 2 contains two sub-parts, Part 2A and Part 2B. Part 2A contains the requirements for the disclosure "brochure" that advisers must provide to prospective clients initially and to existing clients annually, and Part 2B contains information about the advisory personnel providing

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65 See Advisers Act Rules 203-1 and 204-1. Form ADV also is used by state securities regulators to register investment advisers. Advisers may withdraw from registration by filing a Form ADV-W. See Advisers Act Section 203(h). Form ADV-W requires an adviser to provide certain basic information regarding matters such as custody of client assets, money owed to clients, assignment of advisory contracts and the adviser's financial condition, all of which are at ensuring an orderly wind down of the adviser's business.

66 The IARD is operated by FINRA. NSMIA led to a joint agreement among the Commission, state regulators and the NASD to develop the IARD. See Section II.C.1 infra for more info.

67 The IAPD is available on the Commission's website, at http://www.adviserinfo.sec.gov. The Commission recently adopted amendments to Part 2 to require, among other things, that registrants file it electronically. Investment advisers are required to submit Form ADV Part 2 as part of their next annual updating amendment, or upon initial registration. See Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) ("Release 3060"). The Commission has brought enforcement actions against advisers alleging that the advisers failed to properly update the Form. See, e.g., In the Matter of C&G Asset Management, Inc., Investment Advisers Act Release No. 1536 (Nov. 9, 1995) (settled order).

68 The Commission is required to grant registration or institute a proceeding to determine whether registration should be denied within 45 days of the complete Form ADV filing. Advisers Act Section 203(c)(2).

69 See Advisers Act Rule 204-1.

70 See Release 3060, supra note 67.

clients with investment advice.[71] Part 2A contains 18 disclosure items about the advisory firm that must be included in an adviser's brochure (the "firm brochure"). Much of the disclosure in Part 2A addresses an investment adviser's conflicts of interest with its clients, and is disclosure that the adviser, as a fiduciary, must make to clients in some manner regardless of the form requirements.[72] For example, Part 2A requires information about the adviser's:

- Range of fees;
- Methods of analysis;
- Investment strategies and risk of loss;
- Brokerage, including trade aggregation policies and directed brokerage practices, as well as use of soft dollars;
- Review of accounts;
- Client referrals and other compensation;
- Disciplinary history; and
- Financial information, among other things.[73]

Part 2B is the "brochure supplement," which includes information about certain advisory personnel on whom clients may rely for investment advice, including their

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[71] The Commission's recent amendments to Part 2 included a requirement that Commission-registered investment advisers provide prospective and existing clients with a narrative brochure written in plain English. See Release 3060, supra note 67. All investment advisers registered with the Commission as of December 31, 2010, and having a fiscal year ending on December 31, 2010 through April 30, 2011, have until July 31, 2011, to begin delivering brochure supplements to new and prospective clients. These advisers have until September 30, 2011 to deliver brochure supplements to existing clients. Existing registered investment advisers with fiscal years ending after April 30, 2011 must deliver brochure supplements to existing clients within 60 days of filing the annual updating amendment.

All newly registered investment advisers filing their applications for registration from January 1, 2011 through April 30, 2011, have until May 1, 2011 to begin delivering brochure supplements to new and prospective clients. These advisers have until July 1, 2011 to deliver brochure supplements to existing clients. Newly registered investment advisers filing applications for registration after April 30, 2011 must deliver brochure supplements to clients upon registration.

[72] See Release 3060, supra note 67, at 9.

[73] See Part 2A of Form ADV.

educational background, disciplinary history, and the adviser's supervision of the advisory activities of its personnel.[74]

A Commission-registered investment adviser must provide its prospective clients with a current firm brochure before or at the time it enters into an advisory contract with them.[75] Advisers must annually provide to each client to whom they must deliver a firm brochure either: (i) a copy of the current (updated) firm brochure that includes or is accompanied by the summary of material changes that have occurred since their last brochure to clients; or (ii) a summary of material changes that have occurred since their last brochure to clients that includes an offer to provide a copy of the current firm brochure.[76] Each adviser must make this annual delivery no later than 120 days after the end of its fiscal year.[77] Advisers may deliver: (i) the firm brochure and a summary of material changes; or (ii) a summary of material changes, along with an offer to provide the firm brochure to clients electronically in accordance with the Commission's guidelines regarding electronic delivery of information.[78]

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74 See Instruction 5 of General Instructions for Form ADV. Registrants are not required to file Part 2B electronically, but must preserve a copy of the supplement(s) and make them available upon request.

75 See Advisers Act Rule 204-3. The rule does not require advisers to deliver brochures to certain advisory clients receiving only impersonal investment advice for which the adviser charges less than $500 per year, or to clients that are investment companies registered under the Investment Company Act of 1940 ("Investment Company Act") or business development companies provided that the advisory contract with such a company meets the requirements of Investment Company Act Section 15(c), which requires a board of directors to request, and the adviser to furnish, information to enable the board to evaluate the terms of the proposed advisory contract. Finally, an adviser does not have to prepare (or file with the Commission) a brochure if it does not have any clients to whom a brochure must be delivered. See Instruction 7 for Part 2A of Form ADV.

76 See Advisers Act Rule 204-3(b) and Instruction 2 of Part 2A of Form ADV. The offer also must be accompanied by a website address (if available) and a telephone number and e-mail address (if available) for obtaining the complete brochure pursuant to the Instructions for Part 2, as well as the website address for obtaining information about the adviser through the IAPD. Advisers Act Rule 204-2 also requires the adviser choosing this approach to preserve a copy of the summary of material changes, so that the Commission's examination staff has access to such separately provided summaries. See Advisers Act Rule 204-2(a)(14)(i).

77 See Advisers Act Rule 204-3(b) and Instruction 2 for Part 2A of Form ADV.

78 See Release 3060, supra note 67. Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Investment Advisers Act Release No. 1562 (May 9, 1996).

An adviser that does not include, and therefore file, its summary of material changes as part of its firm brochure (on the cover page or the page immediately following the cover) must file its summary as an exhibit, included with its firm brochure when it files its annual updating amendment with the Commission, so that the summary of material changes is available to the public through the IAPD website. See Instruction 6 for Part 2A of Form ADV. The adviser must upload its firm brochure and the summary (as an exhibit) together in a single, text-searchable file in Adobe Portable Document Format (PDF) on IARD. See Instruction 6 for Part 2A of Form ADV.

Use of Solicitors

Advisers Act Rule 206(4)-3 regulates a Commission-registered investment adviser's use of persons to solicit clients and prospective clients for advisory services. The Commission adopted Advisers Act Rule 206(4)-3 in recognition of the inherent conflicts of interest that can be present in arrangements in which an individual receives cash compensation, even on a fully disclosed basis, for referring others to an investment adviser.[79] Advisers Act Rule 206(4)-3 makes it unlawful for any investment adviser that is required to be registered with the Commission to pay a cash fee to a person who solicits clients for the adviser unless, among other things, the investment adviser and the solicitor enter into a written agreement requiring the solicitor to provide certain disclosure to prospective clients. The adviser has an obligation under Rule 206(4)-3 to make a bona fide effort to ascertain whether the solicitor has complied with the agreement, and has a reasonable basis for believing that the solicitor has so complied. The adviser must receive from the prospective client, prior to, or at the time of, entering into any written or oral investment advisory contract with such client, a signed and dated acknowledgment of receipt of the investment adviser's written disclosure statement and the solicitor's written disclosure document.[80] A solicitor cannot be subject to a statutory disqualification.[81] Thus, investment advisers cannot pay cash fees to solicitors unless they meet conditions designed to address the conflicts of interest concerns that are raised by these payments.

b) Regulation Related to the Provision of Personalized Investment Advice to Advisory Clients

Legal Obligations towards Advisory Clients

The Supreme Court has construed Advisers Act Section 206(1) and (2) as establishing a federal fiduciary standard governing the conduct of advisers.[82] The

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79 See, e.g., Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Investment Advisers Act Release No. 615 (Feb. 2, 1978) (proposing Advisers Act Rule 206(4)-3) and Investment Advisers Act Release No. 688 (July 12, 1979) (adopting Advisers Act Rule 206(4)-3).

80 Id. (contains a discussion of an adviser's obligation to supervise cash solicitors acting on its behalf).

81 For example, the solicitor cannot be subject to a Commission order under Advisers Act Section 203(f), convicted within the past 10 years of certain felonies or misdemeanors set forth in Advisers Act Sections 203(e)(2)(A)-(D), found by the Commission to have engaged or been convicted of engaging in certain violative conduct set forth in Advisers Act Section 203(e), or be subject to an order, judgment or decree described in Advisers Act Section 203(e)(3).

82 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963). See also Transamerica Mortgage Advisors, Inc., 444 U.S. 11, 17 (1979) ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

adviser's fiduciary duty is enforceable under Advisers Act Sections 206(1) and (2),[83] which prohibit an adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client" and from engaging in "any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client."

Under the Advisers Act, an adviser is a fiduciary. This fiduciary standard applies to the investment adviser's entire relationship with its clients and prospective clients, imposes upon investment advisers the "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation to 'employ reasonable care to avoid misleading'" their clients and prospective clients.[84]

Fundamental to the federal fiduciary standard are the duties of loyalty and care.[85] The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own.[86] An adviser's duty of care requires it to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[87]

The Commission, the staff, and the courts have articulated guidance on these duties over time through rules, interpretive statements, and orders issued in enforcement actions. This guidance has addressed, among other things, disclosure of conflicts of interest, suitability and reasonable basis for investment advice, and principal trading and cross trading.

Disclosure of Conflicts of Interest

As part of its fiduciary duty, an adviser must fully disclose to its clients all material information that is intended "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[88] The Commission has brought enforcement actions alleging advisers' failures to disclose their conflicts of interest.[89] Under the

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83 See Transamerica, 444 U.S., supra note 82.

84 See Capital Gains, 375 U.S., supra note 82 at 191-192.

85 See, e.g., Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003 ("Release 2106").

86 Id. See also e.g., Release 3060, supra note 67.

87 See Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) ("Release 3052") at 119.

88 Capital Gains, supra note 82.

89 See, e.g., In the Matter of Ronald Speaker, et al., Investment Advisers Act Release No. 1605 (Jan. 13, 1997) (settled order); and In the Matter of Kidder Peabody & Co., Inc., et al., Advisers Act Release No. 232 (Oct. 16, 1968) (settled order) ("Release 232"). The Commission also has brought enforcement actions alleging that an adviser failed to disclose conflicts of interest. See, e.g., Release 3090, supra note 48; In the Matter of Fidelity Management Research Company,

antifraud provisions of the Advisers Act, an investment adviser must disclose material facts to its clients and prospective clients whenever the failure to do so would defraud or operate as a fraud or deceit upon any such person.[90] The adviser's fiduciary duty of disclosure is a broad one, and delivery of the adviser's brochure alone may not fully satisfy the adviser's disclosure obligations.[91]

The duty to disclose material facts applies to conflicts of interest—or potential conflicts of interest—that arise during an adviser's relationship with a client. Therefore, the type of required disclosure will depend on the facts and circumstances. As a general matter, an adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser.[92] For example, if an adviser selects or recommends other advisers for clients, it must disclose any compensation arrangements or other business relationships between the advisory firms, along with the conflicts created, and explain how it addresses these conflicts.[93] In addition, the Commission has brought numerous enforcement

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Investment Advisers Act Release No. 2713 (Mar. 5, 2008) (settled order); Monetta Financial Services, Inc. v. SEC, 390 F.3d 952 (2d Cir. 2004); In the Matter of Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129 (May 15, 2003) (settled order); In the Matter of Deutsche Asset Management, Inc., Investment Advisers Act Release No. 2160 (Aug. 19, 2003) (settled order); In the Matter of Joan Conan, Investment Advisers Act Release No. 1446 (Sept. 30, 1994) (settled order); In the Matter of Kemper Financial Services, Inc., Investment Advisers Act Release No. 1494 (June 6, 1995) (settled order); and In the Matter of Mark Bailey & Co., et al., Investment Advisers Act Release No. 1105 (Feb. 24, 1988) (settled order) ("Release 1105").

See also General Instruction 3 to Part 2 of Form ADV: "Under federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your *clients* that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to *clients* information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require. You may disclose this additional information to *clients* in your *brochure* or by some other means."

90 See Capital Gains, supra note 82. The recent amendments to Part 2 of Form ADV require advisers to respond to a number of disclosure items about conflicts of interest. For example, Item 10 of Part 2A requires an adviser to disclose other financial industry activities and affiliations, any material conflicts of interest that these relationships create and how the adviser addresses these conflicts. See Release 3060, supra note 67.

91 See Instruction 3 of General Instructions for Part 2 of Form ADV; Advisers Act Rule 204-3(f). See also Release 3060, supra note 67.

92 See Release 3060, supra note 67 ("the disclosure clients and prospective clients receive is critical to their ability to make an informed decision about whether to engage an adviser and, having engaged the adviser, to manage that relationship.")

93 See Item 10 of Form Part 2A. The Commission has brought enforcement actions charging advisers with alleged failures to make such disclosures. See, e.g., In the Matter of Morgan Stanley

actions alleging that the advisers unfairly allocated client trades to preferred clients without making adequate disclosure.[94]

Advisers also must disclose their policies and practices with respect to their receipt of research and other "soft dollar" benefits in connection with client securities transactions.[95] The Commission has brought enforcement actions against advisers that allegedly recommended to clients, or bought or sold for clients, securities in which the adviser or a related person had an undisclosed material financial interest.[96]

Principal and Cross Trading Requirements

Advisers are restricted by Advisers Act Section 206(3) when entering into principal and agency-cross trades with their clients. Advisers Act Section 206(3) is intended to address the potential for self-dealing that could arise when an investment adviser acts as principal in transactions with clients, such as through price manipulation

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& Co., Incorporated, Investment Advisers Act Release No. 2904 (July 20, 2009) (settled order); In the Matter of Yanni Partners, Inc., et al., Investment Advisers Act Release No. 2642 (Sept. 5, 2007) (settled order).

94 See, e.g., In the Matter of Nevis Capital Management, LLC, Investment Advisers Act Release No. 2214 (Feb. 9, 2004) (settled order); In the Matter of The Dreyfus Corporation, et al., Investment Advisers Act Release No. 1870 (May 10, 2000) (settled order); In the Matter of Account Management Corporation, Investment Advisers Act Release No. 1529 (Sept. 29, 1995) (settled order). The Commission also has brought numerous enforcement actions against advisers that allegedly unfairly allocated trades to their own accounts and allocated less favorable or unprofitable trades to their clients' accounts. See, e.g., In the Matter of Nicholas-Applegate Capital Management, Investment Advisers Act Release No. 1741 (Aug. 12, 1998) (settled order); In the Matter of Timothy J. Lyons, Investment Advisers Act Release No. 1882 (June 20, 2000) (settled order) and SEC v. Lyons, 57 S.E.C. 99 (2003); and SEC v. Alan Brian Bond, et al., Litigation Release No. 18923 (Civil Action No. 99-12092 (S.D.N.Y.) (Oct. 7, 2004).

95 See Item 12 of Form ADV Part 2A. Advisers often seek research and other products or services from external sources, and particularly from broker-dealers. Although advisers may use their own assets—such as revenues derived from their advisory fees —to purchase such research and services, advisers typically pay for research and other services with a portion of the brokerage commissions paid by clients, a practice referred to as "soft dollars." The use of soft dollars creates a conflict of interest for an investment adviser because the adviser is obtaining brokerage and research services with client commissions instead of purchasing those services with its own funds. See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006) ("2006 Soft Dollar Release"). The 2006 Soft Dollar Release superseded parts (but not all) of the 1986 Soft Dollar Release. In particular, the 2006 Soft Dollar Release does not replace Section IV of the 1986 Release, cited infra, which discusses an investment adviser's disclosure obligations.

96 The Commission has brought enforcement actions against advisers alleging that the advisers did not adequately disclose soft dollar arrangements and related conflicts. See, e.g., In the Matter of Schultze Asset Management LLC, Investment Advisers Act Release No. 2633 (Aug. 15, 2007) (settled order); In the Matter of Rudney Associates, Inc., Investment Advisers Act Release No. 2300 (Sept. 21, 2004) (settled order).

or the dumping of unwanted securities into client accounts.[97] Section 206(3) makes it unlawful for an adviser, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to the transaction.[98] The Commission staff has taken the position that the adviser must disclose not only the capacity in which the adviser is acting, but also any compensation that the adviser receives for its role in such transaction.[99]

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97 See Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 320-22 (1940).

98 Section 206(3) provides that the prohibitions do not apply to any transaction with a customer of a broker-dealer if the broker-dealer is not acting as an investment adviser in relation to the transaction. The Commission has applied Section 206(3) not only to principal transactions engaged in or effected by any adviser, but also when an adviser causes a client to enter into a principal transaction that is effected by a broker-dealer that controls, is controlled by, or is under common control with, the adviser (a "control affiliate"). See Interpretation of Section 206(3) of the Advisers Act of 1940, Investment Advisers Act Release No. 1732, at n.3 (July 17, 1998) ("Release 1732"). The Commission has brought enforcement actions alleging violations of Section 206(3) against investment advisers that have effected principal transactions, including "riskless principal transactions," through control affiliates without complying with the disclosure and consent requirements of Section 206(3). See, e.g., In the Matter of Rothschild Investment Corporation, Investment Advisers Act Release No. 1714 (Apr. 13, 1998) (settled order); In the Matter of Stern Fisher Edwards Inc., Investment Advisers Act Release No. 1803 (June 18, 1999) (settled order); In the Matter of ABN AMRO-NSM International Funds Management, B.V., Investment Advisers Act Release No. 1767 (Sept. 30, 1998) (settled order); In the Matter of Calamos Asset Management, Investment Advisers Act Release No. 1589 (Oct. 16, 1996) (settled order); and In the Matter of Concord Investment Co., Investment Advisers Act Release No. 1585 (Sept. 27, 1996) (settled order).

The Commission staff has stated that whether Section 206(3) applies to transactions between an adviser's client and an unregistered pool investment vehicle in which the adviser has an ownership interest depends upon all of the facts and circumstances. The Commission staff also has stated that a transaction between a client account and a pooled investment vehicle of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less should not implicate Advisers Act Section 206(3). See Gardner Russo & Gardner, SEC Staff No-Action Letter (June 7, 2006).

The Commission has brought enforcement actions asserting violations of Section 206(3) by advisers and their principals when the advisers effected transactions between their advisory clients and accounts in which the principals of the advisers held significant ownership interests. See SEC v. Beacon Hill Asset Management, LLC, Litigation Release No. 18950 (Oct. 28, 2004); and In the Matter of Gintel Asset Management, Investment Advisers Act Release No. 2079 (Nov. 8, 2002) (settled order).

99 See, e.g., Release 1092, supra note 53 and Opinion of Director of Trading and Exchange Division, Investment Advisers Act Release No. 40 (Feb. 5, 1945) ("Release 40").

For purposes of Section 206(3), the Commission interprets "before the completion of the transaction" to mean by settlement of the transaction.[100] But in order for post-execution, pre-settlement consent to comply with Section 206(3), the adviser must provide both sufficient disclosure for a client to make an informed decision, and the opportunity for the client to withhold consent.[101] While the disclosure must be in writing, Section 206(3) does not require that the client's consent be in writing. Written disclosure must be provided and consent must be obtained separately for each transaction, i.e., a blanket consent for transactions is not sufficient.[102]

Compliance with the disclosure and consent provisions of Advisers Act Section 206(3) provision alone does not satisfy an adviser's fiduciary obligations with respect to a principal trade. The Commission has stated that Section 206(3) must be read together with Advisers Act Sections 206(1) and (2) to require that the adviser disclose additional facts necessary to alert the client to the adviser's potential conflict of interest in the principal trade.[103]

The Commission has adopted less rigorous requirements for engaging in agency-cross trades (i.e., where the adviser is also a broker-dealer and executes the client's orders by crossing the orders with orders of non-advisory clients) by relaxing the prior disclosure and consent requirement for each such trade.[104] At times it may benefit the client for an adviser to engage in an agency-cross trade. For example, agency-cross trades can save brokerage commissions and other transaction costs. Advisers Act Rule 206(3)-2 permits these agency-cross transactions without requiring the adviser to provide transaction-by-transaction disclosure to the client if, among other things:

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100 See Release 1732, supra note 98.

101 Id.

102 See Release 40, supra note 99. The Commission has brought enforcement actions against investment advisers for allegedly violating Advisers Act Section 206(3) when they entered into principal transactions with their clients using only prior blanket disclosures and consents. See, e.g., In the Matter of Stephens, Inc., Investment Advisers Act Release No. 1666 (Sept. 16, 1997) (settled order); In the Matter of Clariden Asset Management (New York) Inc., Investment Advisers Act Release No. 1504 (July 10, 1995) (settled order).

Under Advisers Act Rule 206(3)-1, the notice and consent provisions of Section 206(3) do not apply to any transaction in which the broker-dealer is acting as investment adviser solely (1) by means of publicly distributed written materials or publicly made oral statements; (2) by means of written materials or oral statements which do not purport to meet the needs of specific individuals or accounts; (3) through the issuance of certain statistical information; or (4) any combination of the foregoing services. See also Temporary Rule Advisers Act 206(3)-3T which provides an alternative means of compliance with Section 206(3) for advisers that also are registered broker-dealers.

103 See Release 1732, supra note 98.

104 See Release 1732, supra note 98 (stating that an adviser is not "acting as broker" within the meaning of Advisers Act Section 206(3) if the adviser receives no compensation (other than its advisory fee) for effecting a particular agency transaction between advisory clients).

- the client has executed a written consent after receiving full disclosure of the conflicts involved, which must be renewed each year;

- the adviser (or any other person relying on Rule 206(3)-2) provides a written confirmation to the client at or before the completion of each transaction providing, among other things, the source and amount of any remuneration it received;

- the adviser (or any other person relying on Rule 206(3)-2) provides the client with an annual summary of all agency cross transactions; and

- the disclosure document and each confirmation conspicuously disclose that consent may be revoked at any time.[105]

The rule does not apply to a transaction when the adviser or the adviser and any person controlling, controlled by, or under common control with the adviser recommended the transaction to both the purchaser and seller. The rule does not relieve advisers from the duty to act in the best interests of their clients, including the duty to seek to obtain best price and execution for any transaction.[106]

Effecting cross-trades between clients (where a third-party broker is used) is not specifically addressed by the Advisers Act, but the Commission has brought enforcement actions against investment advisers alleging that the advisers failed to seek best execution in securities transactions for certain advisory clients because of an undisclosed trading practice involving cross trades between client accounts.[107] Cross trades involve potential conflicts of interest (because the adviser could favor one client over another; the adviser's duty of loyalty requires it to act in the best interests of each client). The Commission has brought enforcement actions alleging an adviser's failure to fulfill this obligation.[108]

Suitability and Reasonable Basis

Investment advisers owe their clients the duty to provide only suitable investment advice.[109] To fulfill the obligation, an adviser must make a reasonable determination that

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105 Advisers Act Rule 206(3)-2.

106 See Agency Cross Transactions for Advisory Clients, Investment Advisers Act Release No. 589 (June 1, 1977) (adopting Rule 206(3)-2).

107 See, e.g., In the Matter of Renberg Capital Management, Inc., et al., Investment Advisers Act Release No. 2064 (Oct. 1, 2002) (settled order) ("Release 2064").

108 See, e.g., In the Matter of David A. King, et al, Investment Advisers Act Release No. 1391 (Nov. 9, 1993) (settled order).

109 See Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) (in the context of adopting a final rule providing for a non-exclusive safe harbor from the definition of investment company for

the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.

In addition, as a fiduciary, an investment adviser has "a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[110] The investment adviser must disclose its investment process to clients. For example, Item 8 of Form ADV Part 2A requires an investment adviser to describe its methods of analysis and investment strategies, among other things. This item also requires that an adviser explain the material risks involved for each significant investment strategy or method of analysis it uses and particular type of security it recommends, with more detail if those risks are significant or unusual.[111]

Best Execution

Investment advisers have an obligation to seek best execution of clients' securities transactions where they have the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts).[112] In meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients in such a manner that the client's total cost or proceeds in each transaction are the most favorable under the circumstances.[113]

When seeking best execution, an adviser should consider the full range and quality of a broker's services when selecting broker-dealers to execute client trades,

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certain investment advisory programs), citing to Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994) (proposing a rule under the Advisers Act Section 206(4)'s antifraud provisions that would expressly require advisers to give clients only suitable advice; the rule would have codified existing suitability obligations of advisers) ("Release 1406").

110 See Release 3052, supra note 87.

111 The Commission has brought enforcement actions alleging omissions and misrepresentations regarding investment strategies. See, e.g., In the Matter of George F. Fahey, Investment Advisers Act Release No. 2196 (Nov. 24, 2003) (settled order); and In the Matter of Gary L. Hamby, et al., Investment Advisers Act Release No. 1668 (Sept. 22, 1997) (settled order).

112 See Advisers Act Rule 206(3)-2(c) (acknowledging adviser's duty of best execution of client transactions). See also 2006 Soft Dollar Release, supra note 95 (stating that investment advisers have "best execution obligations"). See also Release 3060, supra note 67.

113 See 1986 Soft Dollars Release, cited infra. The Commission has brought enforcement actions alleging failure to seek best execution. See, e.g., In the Matter of Value Line, Inc. et al., Investment Advisers Act Release No. 3100 (Nov. 2, 2010) (settled order); In the Matter of Fidelity Management Research Company, Investment Advisers Act Release No. 2713 (Mar. 5, 2008) (settled order); Release 2064, supra note 107; In the Matter of Portfolio Advisory Services, LLC, Investment Advisers Act Release No. 2038 (June 20, 2002) (settled order); In the Matter of Sage Advisory Services LLC, Investment Advisers Act Release No. 1954 (July 27, 2001) (settled order); In the Matter of Fleet Investment Advisors, Inc., Investment Advisers Act Release No. 1821 (Sept. 9, 1999) ("Release 1821"); Release 232, supra note 89.

including, among other things, the broker's execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided.[114] An investment adviser should "periodically and systematically" evaluate the execution it is receiving for clients.[115]

The Advisers Act does not prohibit advisers from using an affiliated broker to execute client trades or from directing brokerage to certain brokers. However, the adviser's use of such an affiliate involves a conflict of interest that must be disclosed to the adviser's client.[116] To this end, Item 12 of Part 2A of Form ADV also requires an adviser to describe any relationship with a broker-dealer to which the brokerage may be directed that creates a material conflict of interest.[117]

- Aggregation of Orders

Clients engaging an adviser can benefit when the adviser aggregates trades to obtain volume discounts on execution costs.[118] The staff takes the position that an adviser, when directing orders for the purchase or sale of securities, may aggregate or "bunch" those orders on behalf of two or more of its accounts, so long as the bunching is done for the purpose of achieving best execution, and no client is advantaged or disadvantaged by the bunching.[119] Item 12 of Part 2A of Form ADV requires the adviser to describe whether and under what conditions it aggregates trades; if the adviser does not aggregate trades when it has the opportunity to do so, the adviser must explain in the brochure that clients may therefore pay higher brokerage costs.

Advertising

Advertising by investment advisers is subject both to the general antifraud provisions in Advisers Act Sections 206(1) and (2) and to specific prohibitions and

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114 See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986) ("1986 Soft Dollar Release").

115 Id.

116 See 1986 Soft Dollar Release, supra note 114. The Commission has brought enforcement actions charging advisers with defrauding their clients for failing to disclose that they directed their brokerage commissions in return for client referrals. See, e.g., In the Matter of Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129 (May 15, 2003) (settled order); In the Matter of Duff & Phelps Investment Management Co., Inc., Investment Advisers Act Release No. 1984 (Sept. 28, 2001) (settled order); Release 1821, supra note 113; In the Matter of MPI Investment Management, et al., Investment Advisers Act Release No. 1876 (June 12, 2000) (settled order); and Release 1105, supra note 89.

117 See Item 12.A.3.a of Part 2A.

118 See Release 3060, supra note 67.

119 See SMC Capital, Inc., SEC Staff No-Action Letter (Sept. 5, 1995).

restrictions under Advisers Act Rule 206(4)-1. Rule 206(4)-1 generally prohibits any investment adviser that is registered or required to be registered under the Advisers Act from using any advertisement that contains any untrue statement of a material fact or is otherwise false or misleading. [120]

As the Commission stated in adopting Advisers Act Rule 206(4)-1, "when considering the provisions of the rule it should be borne in mind that investment advisers are professionals and should adhere to a stricter standard of conduct than that applicable to merchants, securities are "intricate merchandise," and clients or prospective clients of investment advisers are frequently unskilled and unsophisticated in investment matters."[121] While investment advisers are prohibited under Advisers Act Sections 206(1) and (2) from making any communications to clients that are misleading, the prohibitions in Rule 206(4)-1 apply only to "advertisements" by advisers, which the Commission defines generally as written (including electronic) or broadcast communications to more than one person that offer advisory services.[122]

The Commission staff considers an advertisement containing performance information misleading if it implies, or if a reader would infer from it, something about an adviser's competence or possible future investment results that would be unwarranted if the reader knew all of the facts.[123] The staff has provided extensive guidance

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120 Advisers Act Rule 206(4)-1. The Commission has brought enforcement actions against advisers for false or misleading advertising. See, e.g., In the Matter of Warwick Capital Management, Investment Advisers Act Release Nos. 2694 (Jan. 16, 2008) and 2530 (July 6, 2006) ("Warwick Capital"); In the Matter of First Command Financial Planning, Inc., Securities Act Release No. 8513 (Dec. 15, 2004) (settled order); In the Matter of Justin S. Mazzon d/b/a American Blue Chip Investment Management, Investment Advisers Act Release No. 2145 (July 14, 2003) (settled order); In the Matter of LBS Capital Management, Inc., Investment Advisers Act Release No. 1644 (July 18, 1997) (settled order); SEC v. C.R. Richmond & Co., 565 F.2d 1101, 1104 (9th Cir. 1977).

121 Adoption of Rule 206(4)-1 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 121 (Nov. 2, 1961) ("Release 121").

122 Advisers Act Rule 206(4)-1(b) defines advertisement for purposes of the rule as

> [a]ny notice circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

A communication covered by the rule may be made to new clients or to existing clients where the purpose is to induce them to renew their advisory contract or subscription. See Spear & Staff, 42 S.E.C. 549 (1965).

123 See, e.g., Clover Capital Management, Inc., SEC Staff No-Action Letter (Oct. 28, 1986).

concerning the circumstances under which adviser investment performance information would or would not be considered misleading.[124] Advisers registered with the Commission must maintain records substantiating any performance claimed in an advertisement or other communication that goes to ten or more persons.[125]

In addition to that general prohibition, Advisers Act Rule 206(4)-1 also contains specific provisions that prohibit such an investment adviser from directly or indirectly, publishing, circulating or distributing an advertisement that:

- Refers to any testimonial concerning an investment adviser or its services;[126]

- Refers to past specific recommendations made by the adviser, which were or would have been profitable to any person, except under specified circumstances;[127]

- Represents that any graph, chart, formula or other device can, in and of itself, be used to determine which securities to buy or sell or when to buy or sell them, without disclosing the limitations thereof and the difficulties with respect to its use; or[128]

- Refers to any report, analysis, or service as free, unless it actually is free and without condition or obligation.[129]

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124 See, e.g., Horizon Asset Management, SEC Staff No-Action Letter (Sept. 13, 1996); J.P. Morgan Investment Management Inc., SEC Staff No-Action Letter (May 7, 1996).

125 Advisers Act Rule 204-2(a)(16). See, e.g., Warwick Capital, supra note 120.

126 Advisers Act Rule 206(4)-1(a)(1). The Commission staff has stated that testimonials include any statement of a client's experience with, or endorsement of, an adviser. See DALBAR, Inc., SEC Staff No-Action Letter (Mar. 24, 1998). In addition, the Commission staff has taken the position that an advertisement containing a partial client list was not a testimonial within the meaning of Rule 206(4)-1(a)(1), and agreed not to recommend enforcement action under Advisers Act Section 206(4) and Advisers Act Rule 206(4)-1(a)(5) if an adviser distributed an advertisement that contained a partial client list if the selection criteria were objective and unrelated to the performance of the clients' accounts, and the advertisement contained certain disclosure and a disclaimer. See, e.g., Cambiar Investors, Inc., SEC Staff No-Action Letter (Aug. 28, 1997).

127 Advisers Act Rule 206(4)-1(a)(2). The rule requires that if the adviser refers to past specific recommendations, it must set out a list of all recommendations made by the adviser during the preceding year that contain certain information specified in the rule. The Commission staff has taken the view that in certain circumstances, advisers could provide reports to prospective and existing clients that identified some, but not all, past specific recommendations under conditions designed to ensure that the reports did not raise the dangers that Advisers Act Rule 206(4)-1(a)(2) was designed to prevent. See, e.g., The TCW Group Inc., SEC Staff No-Action Letter (Nov. 7, 2008) and Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998).

128 Advisers Act Rule 206(4)-1(a)(3).

129 Advisers Act Rule 206(4)-1(a)(4).

The use of testimonials is prohibited because of the Commission's concern that they will create a misleading inference that all of the adviser's clients will experience such favorable results.[130] Similarly, the limitations on references to past recommendations are aimed at preventing the adviser from selectively emphasizing profitable recommendations and therefore misleading potential clients.[131]

Additional Substantive Requirements

Advisers Act Section 206 generally prohibits an investment adviser (whether registered or exempt from registration) from engaging in fraudulent, deceptive, or manipulative activities. Advisers Act Section 206(4) provides the Commission with rulemaking authority to define such activities and prescribe reasonable means to prevent them. The following sections provide additional examples of investment adviser regulation intended to promote the adviser's fiduciary duties and to protect advisory clients, including examples of specific rules adopted under Advisers Act Section 206(4) (e.g., custody, compliance, and proxy voting).

In addition, the following sections also discuss other Advisers Act requirements, including recordkeeping, supervision, disclosure of disciplinary history, contractual requirements, and remedies.

Recordkeeping

Advisers that are registered or required to be registered under the Advisers Act are subject to recordkeeping requirements. Generally, Advisers Act Rule 204-2 requires an adviser to maintain business accounting records as well as various specified records that relate to its advisory business. For example, advisers must maintain, among other things, the following:

- General and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts;

- A memorandum of any order given and instructions received by the adviser from clients for the purchase, sale, delivery or receipt of securities

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130 See Release 121, supra note 121 (adopting Rule 206(4)-1, stating "the Commission finds that such advertisements are misleading; by their very nature they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable. This is true even when the testimonials are unsolicited and are printed in full.").

131 Id., stating: "the Commission believes that material of this nature, which may refer only to recommendations which were or would have been profitable and ignore those which were or would have been unprofitable, is inherently misleading and deceptive, and consequently the rule prohibits this type of advertising unless all recommendations for a minimum specified period are included."

(including terms and conditions of any order, who recommended and placed the order, the account and date of entry and who executed the order);

- Trial balances, financial statements, any internal audit papers relating to adviser's business;

- Original or copies of certain communications sent to or received by the adviser (including responses to requests for detailed investment advice, placement or execution of securities orders, receipt or delivery of securities or funds);

- A list of and documents relating to the adviser's discretionary client accounts (including powers of attorney or grants of authority);

- Copies of publications and recommendations the adviser distributed to 10 or more persons and a record of the factual basis and reasons for the recommendation; and

- A record of certain securities transactions in which the adviser or advisory representatives have a direct or indirect beneficial ownership interest.

Additional records must be maintained in certain circumstances (e.g., if an investment adviser has custody of client assets or exercises proxy voting authority with respect to client securities).[132] Generally, all required books and records must be maintained and preserved in an adviser's office for two years after the last entry date and three additional years in an easily accessible place.[133] Records may be stored on micrographic or electronic storage media, subject to certain conditions ensuring safekeeping and accessibility.[134]

Advisers Act Section 204 provides that all records of an investment adviser (other than investment advisers that are specifically exempted from registration under Advisers Act Section 203(b)) are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

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132 See Advisers Act Rule 204-2(b) and Rule 204-2(c)(2), respectively.

133 See Advisers Act Rule 204-2(e)(1).

134 See Advisers Act Rule 204-2(g).

Custody of Client Assets

Advisers Act Rule 206(4)-2 regulates the custody practices of investment advisers registered or required to be registered under the Advisers Act. Rule 206(4)-2 requires advisers that have custody of client funds or securities to implement controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses, such as insolvency. Unlike banks and broker-dealers, investment advisers typically do not maintain physical custody of client funds or securities but rather may have custody because they have the authority to obtain client assets, such as by deducting advisory fees from a client account, writing checks or withdrawing funds on behalf of a client, or by acting in a capacity, such as general partner of a limited partnership, that gives an adviser or its supervised person the authority to withdraw funds or securities from the limited partnership's account.[135]

An adviser has custody of client funds or securities if it "hold[s], directly or indirectly, client funds or securities, or [has] any authority to obtain possession of them in connection with advisory services [it provides] to clients." Custody includes:

- Possession of client funds or securities;
- Any arrangement under which an adviser is permitted or authorized to withdraw client funds or securities (such as check-writing authority or the ability to deduct fees from client assets); and
- Any capacity that gives an adviser or its supervised person legal ownership of or access to client funds or securities (such as acting as general partner, managing member or trustee).[136]

An adviser also has custody of any client securities or funds that are directly or indirectly held by a "related person" in connection with advisory services provided by the adviser to its clients.[137] A related person is defined by the rule as a person directly or indirectly controlling or controlled by the adviser and any person under common control with the adviser. [138]

A registered adviser with custody of client funds or securities is required to take a number of steps designed to safeguard those client assets.[139] The adviser must maintain

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135 See Advisers Act Rule 206(4)-2(d)(2)(iii).

136 See Advisers Act Rule 206(4)-2(d)(2).

137 Id.

138 See Advisers Act Rule 206(4)-2(d)(7). For advisers that are part of multi-service financial organizations, for example, such related person custodians may include broker-dealers and banks.

139 See Advisers Act Rule 206(4)-2. See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) ("Release 2968"). See also Commission Guidance Regarding Independent Public Accountants Engagements Performed

client funds and securities with "qualified custodians," such as a bank or a broker-dealer, and make due inquiry to ensure that the qualified custodian sends account statements directly to the clients.[140] The adviser must promptly notify its clients as to where and how the funds or securities will be maintained, when the account is opened and following any changes to this information.[141]

Generally, all advisers with custody of client assets must undergo an annual surprise examination by an independent public accountant to verify client assets.[142] In addition, if the adviser itself maintains, or if it has custody because a related person maintains, client assets as a qualified custodian, it must obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board.[143]

Supervision and Compliance

Under the Advisers Act, an investment adviser is subject to liability for failure reasonably to supervise persons subject to its supervision, with a view to preventing violations of the federal securities laws and their rules and regulations. An adviser will not be deemed to have failed reasonably to supervise if (i) the adviser had established procedures, and a system for applying such procedures, reasonably designed to prevent and detect such violations insofar as practicable, and (ii) the adviser reasonably discharged its supervisory duties and obligations, and had no reasonable cause to believe that the procedures and system were not being complied with.[144] Similarly, an associated person may be held liable for failure to supervise under the same circumstances.[145] The Commission has brought enforcement actions against investment advisers and associated persons alleging a failure to supervise.[146]

Pursuant to Rule 206(4)-2 under the Advisers Act, Investment Advisers Act Release No. 2969 (Dec. 30, 2009).

140 Advisers Act Rule 206(4)-2(a)(1).

141 Advisers Act Rule 206(4)-2(a)(2). The adviser need not give a notice if the client opens the account with a custodian himself. If the adviser sends account statements to the client, it must include a legend in the notice urging clients to compare the account statements they receive from the custodian with those they receive from the adviser.

142 Advisers Act Rule 206(4)-2(a)(4).

143 Advisers Act Rule 206(4)-2(a)(6).

144 Advisers Act Section 203(e)(6).

145 Advisers Act Section 203(f).

146 See, e.g., Shearson Lehman Brothers, Inc., Investment Advisers Act Release No. 1038 (Sept. 24, 1986) (settled order); In the Matter of Robert T. Littell, Investment Advisers Act Release No. 2203 (Dec. 15, 2003) (settled order); and In the Matter of Western Asset Management Co., Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (settled order).

Each adviser that is registered or required to be registered under the Advisers Act is required by Advisers Act Rule 206(4)-7 to establish an internal compliance program that addresses the adviser's performance of its fiduciary and substantive obligations under the Advisers Act. The rule requires each adviser to also adopt and implement written policies and procedures reasonably designed to prevent the adviser and its personnel from violating the Advisers Act. Advisers Act Rule 206(4)-7 requires each adviser to review the effectiveness of the policies and procedures at least annually. The rule requires an adviser to designate a chief compliance officer ("CCO"). The Commission has stated that the CCO should be knowledgeable about the Advisers Act and have the authority to develop and enforce appropriate compliance policies and procedures for the adviser.[147] The Commission has stated that an adviser's policies and procedures, at a minimum, should address the following issues to the extent relevant to that adviser:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;

- Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;

- Proprietary trading of the adviser and personal trading activities of supervised persons;

- The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;

- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

- The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

- Marketing advisory services, including the use of solicitors;

- Processes to value client holdings and assess fees based on those valuations;

- Safeguards for the privacy protection of client records and information; and

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147 See Compliance Programs of Investment Advisers and Investment Companies; Investment Advisers Act Release No. 2204 (Dec. 17, 2003) ("Release 2204") (adopting Advisers Act Rule 206(4)-7).

- Business continuity plans.[148]

- Code of Ethics and Personal Securities Transactions

Each investment adviser that is registered with the Commission or required to be registered with the Commission must also adopt a written code of ethics.[149] At a minimum, the adviser's code of ethics must address the following areas:

- *Standards of Conduct.* Set forth a minimum standard of conduct for all supervised persons, which must reflect the adviser's and its supervised persons' fiduciary obligations;

- *Compliance with Federal Securities Laws.* Require supervised persons to comply with federal securities laws;

- *Personal Securities Transactions.* Require each access person[150] to report his or her securities holdings at the time that the person becomes an access person and at least once annually thereafter and to make a report at least once quarterly of all personal securities transactions in reportable securities to the adviser's CCO or other designated person;

- *Pre-approval of Certain Securities Transactions.* Require the CCO or other designated person(s) to pre-approve investments by the access persons in IPOs or limited offerings;

- *Reporting Violations.* Require all supervised persons to promptly report any violations of the code to the adviser's CCO or other designated person(s); and

- *Distribution and Acknowledgment.* Require the adviser to provide each supervised person with a copy of the code, and any amendments, and to obtain a written acknowledgment from each supervised person of his or her receipt of a copy of the code.

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148 Id.

149 Advisers Act Section 204A, and Advisers Act Rule 204A-1.

150 Advisers Act Rule 204A-1(e)(1) defines "access person." Generally, an access person is a supervised person who has access to non-public information regarding clients' securities purchases or sales of securities. If an investment adviser's primary business is providing investment advice, all of the adviser's directors, officers, and partners are also presumed to be access persons.

Under Advisers Act Rule 204-2, the adviser is also required to keep copies of the code, records of violations of the code and of any actions taken against violators of the code, and copies of each supervised person's acknowledgement of receipt of a copy of the code.[151] An adviser must describe its code of ethics in Item 11 of Part 2A of its Form ADV and must offer to provide clients with a copy of its code of ethics upon request.

Disclosure of Disciplinary History and Material Financial Condition to Clients

Advisers must disclose information about the disciplinary history of the firm and its personnel in Part 1A, Item 11 of Form ADV. This information is available to the public through the IAPD. Item 9 of Part 2A of Form ADV requires that an adviser disclose in its firm brochure material facts about any legal or disciplinary event that is material to a client's (or prospective client's) evaluation of the adviser or the integrity of its management personnel.[152] Item 3 of the brochure supplement (Part 2B of Form ADV) requires similar disclosure relating to the advisory personnel's integrity.[153]

Item 18 of Part 2A requires disclosure of specified financial information about an adviser under certain circumstances. Specifically, an adviser that requires prepayment of fees of more than $1,200 in fees per client and six month or more in advance must give clients an audited balance sheet showing the adviser's assets and liabilities at the end of its most recent fiscal year. The item also requires an adviser to disclose any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than $1,200 in fees per client and six months or more in advance. The Commission has stated that disclosure may be required where a judgment or arbitration award was sufficiently large that payment of it would create such a financial condition.[154] Item 18 requires an adviser that has been the subject of a bankruptcy petition during the past ten years to disclose that fact to clients.

The Commission has stated that advisers that are not required to deliver a firm brochure (e.g., they have clients to whom they provide impersonal advice) are required by their fiduciary duty to disclose all material information relating to their disciplinary

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151 See Advisers Act Rule 204-2(a)(12)-(13).

152 See Release 3060, supra note 67 at note 103. These requirements incorporate into the brochure the client disclosure regarding disciplinary information previously required by Advisers Act Rule 206(4)-4 (now rescinded).

153 The list parallels the list of legal and disciplinary events in Item 9 of Part 2A that must be disclosed in the firm brochure and which are derived from the prior disclosure requirements set out in Advisers Act Rule 206(4)-4.

154 See Release 3060, supra note 67 at 43-44 ("Under these circumstances, clients are exposed to the risk that their assets may not be properly managed — and prepaid fees may not be returned — if, for example, the adviser becomes insolvent and ceases to do business.")

history and their abilities to meet their contractual obligations. Failure to do so may violate, among other things, Advisers Act Sections 206(1) and/or (2).[155]

Proxy Voting

The Commission adopted Advisers Act Rule 206(4)-6 to address the adviser's fiduciary duties to its clients when the adviser has authority to vote their proxies. In adopting the rule, the Commission stated:

> Under the Advisers Act, an adviser, as a fiduciary, owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies.[156]

To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subordinate client interests to its own.

Specifically, Advisers Act Rule 206(4)-6 requires an adviser that is registered with the Commission or required to be registered with the Commission and that has voting authority over client securities to:

- Adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the clients' best interests,[157] and that must specifically address conflicts of interest that may arise between the adviser and its clients;

- Describe its voting policies and procedures to clients, deliver a copy of the policies and procedures to clients upon request, and inform clients how they can obtain information on how the adviser voted their securities; and

- Keep certain records relating to voting of client securities.

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155 See Release 3060, supra note 67 at note 103.

156 See Release 2106, supra note 85, citing to Capital Gains, supra note 82.

157 The Commission stated that "an adviser should have procedures in place designed to ensure that it fulfills its duties of monitoring corporate actions and voting client proxies. However, an adviser that fails to vote every proxy would not necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies." See Release 2106, supra note 85.

The Commission has brought enforcement actions against advisers alleging that they failed to disclose to clients the advisers' proxy-related conflicts.[158]

Contractual Requirements

- Fees

Advisers are required to disclose to clients how they are compensated for their services. Part 2A of Form ADV, Item 5 requires that an adviser describe in its firm brochure how it is compensated for its advisory services, provide a fee schedule, and disclose whether fees are negotiable.[159] An adviser must disclose whether it bills clients or deducts fees directly from clients' accounts, and how often it assesses fees (or bills clients).[160] The item also requires each adviser to describe the types of other costs, such as brokerage, custody fees and fund expenses, that clients may pay in connection with the advisory services provided to them by the adviser.[161] An adviser charging fees in advance must explain how it calculates and refunds prepaid fees when a client contract terminates.[162] The Commission staff has taken the view that as part of their fiduciary duties, advisers must charge fees that are fair and reasonable, and when an adviser's fee is higher than others, an adviser must disclose this.[163]

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158 See In the Matter of Deutsche Asset Management, Inc., Investment Advisers Act Release No. 2160 (Aug. 19, 2003) (settled order) and In the Matter of INTECH Investment Management, Investment Advisers Act Release No. 2872 (May 7, 2009) (settled order).

159 See Item 5.A of Part 2A.

160 See Item 5.B of Part 2A.

161 See Item 5.C of Part 2A.

162 See Item 5.D of Part 2A. Item 18 of Part 2A also requires the disclosure of certain financial information about an adviser that requires prepayment of fees of more than $1,200 per client and six months or more in advance.

163 See, e.g., Shareholder Service Corp., SEC Staff No-Action Letter (Feb. 3, 1989) stating:

> With respect to Section 206 and fees in general, the staff believes that an investment adviser who charges a fee for his services larger than that normally charged by other advisers (taking into consideration factors such as the size, location, and nature of the advisory businesses to be compared) has a duty to disclose to his clients that the same or similar services may be available at a lower fee. Beyond that disclosure obligation, the staff generally believes that whether a particular fee violates section 206 depends upon whether the fee is reasonable in relation to the services provided, which necessarily involves examining the facts and circumstances surrounding a particular adviser/client relationship. Among the factors to be considered are (1) the customary fees charged by other advisers for comparable services, (2) whether the same services could be obtained by the client directly without the adviser's assistance and cost, and (3) whether the adviser has a reasonable belief that his services would generate gains in excess of the fee charged.

Item 5 of Part 2A of Form ADV also requires an adviser that receives compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions), or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates, and to describe how the adviser addresses this conflict.[164] Such an adviser also must disclose that the client may purchase the same security or investment product from a broker that is not affiliated with the adviser.[165]

Generally, investment advisers that are registered or required to be registered with the Commission are prohibited by Advisers Act Section 205(a)(1) from entering into a contract with any client that provides for compensation based on a share of the capital gains or appreciation of a client's funds, i.e., a performance fee.[166] Section 205(a)(1) is

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See also H&H Investments, SEC Staff No-Action Letter (Sept. 17, 1981) (adviser charged fee of 6% per month (72% per year), implying that H & H has a reasonable belief that it can produce gains in excess of 6% per month. The staff believed that in the absence of a reasonable basis for such a belief, which should be disclosed to potential clients, H & H's fee would violate Advisers Act Section 206).

164 See Item 5.E of Part 2A. Because of this conflict of interest, the Commission has brought enforcement actions under the antifraud provisions of the Advisers Act charging advisers with failures to disclose receipt of transaction-based compensation. See, e.g., In the Matter of Financial Design Associates, Inc., Investment Advisers Act Release No. 2654 (Sept. 25, 2007) (settled order); In the Matter of IMS, CPAs & Associates, Investment Advisers Act Release No. 1994 (Nov. 5, 2001) (petitioners' appeal denied in Vernazza v. SEC, 327 F.3d 851 (9th Cir. 2003)).

As discussed in Section II.B.2 infra, the Exchange Act generally requires brokers and dealers to register with the Commission and become members of at least one self-regulatory organization. Exchange Act Sections 15(a) and 15(b)(8), Exchange Act Section 3(a)(4)(A) generally defines a "broker" as any person engaged in the business of effecting transactions in securities for the account of others. The Commission staff has taken the position that a person's receipt of transaction-based compensation in connection with effecting transactions in securities for the account of others is a hallmark of broker-dealer activity. See Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, to Thomas D. Giachetti, Stark & Stark, regarding 1st Global, Inc. (May 7, 2001) (reiterating the staff's position that "the receipt of securities commissions or other transaction related [sic] compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer. Absent an exemption, an entity that receives commissions or other transaction-related compensation in connection with securities-based activities that fall within the definition of 'broker' or 'dealer' ... generally is required to register as a broker-dealer." (internal citations omitted)). Investment advisers receiving transaction-based compensation would also need to consider whether they are obligated to register as broker-dealers under Exchange Act Section 15 or whether they can avail themselves of an exception or exemption from registration.

165 See Item 5.E.2 of Part 2A. In addition to the requirement in Item 5.E.2 of Part 2A, an adviser that receives more than half of its revenue from commissions and other sales-based compensation must explain that commissions are the firm's primary (or, if applicable, exclusive) form of compensation. See Item 5.E.3 of Part 2A. An adviser that charges advisory fees in addition to commissions or markups to an individual client must disclose whether it reduces its fees to offset the commissions or markups. See Item 5.E.4 of Part 2A.

166 Advisers Act Section 205(a)(1). The Commission staff has taken the position that Section 205(a)(1)'s prohibition of investment advisory contracts that contain performance fees extends to

designed, among other things, to eliminate "profit sharing contracts [that] are nothing more than 'heads I win, tails you lose' arrangements,"[167] and that "encourage advisers to take undue risks with the funds of clients,"[168] to speculate, or to overtrade.[169] There are several exceptions to the prohibition, mostly applicable to advisory contracts with institutions and high net worth clients.[170]

Registered advisers also are required to provide certain disclosures to their clients if they charge performance-based fees. Item 6 of Part 2A of Form ADV requires an adviser that charges performance-based fees or that has a supervised person who manages an account that pays such fees to disclose this fact in its firm brochure. If such an adviser also manages accounts that are not charged a performance fee, the item also requires the adviser to discuss the conflicts of interest that arise from its (or its supervised person's) simultaneous management of these accounts, and to describe generally how the adviser addresses those conflicts.

- Assignment

Any advisory contract entered into by an adviser that is registered or required to be registered with the Commission must provide in substance that it may not be assigned without consent of the client.[171] An assignment generally includes any direct or indirect transfer of an advisory contract by an adviser or any transfer of a controlling block of an

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investment advisory contracts that provide for "contingent fees." Contingent Advisory Compensation Arrangements, Investment Advisers Act Release No. 721 (May 16, 1980). A contingent fee is "an advisory fee [that] will be waived or refunded, in whole or in part, if a client's account does not meet a specified level of performance" or that is contingent on the investment performance of the funds of advisory clients. Dodd-Frank Act Section 928 amended Advisers Act Section 205(a)(1) to make it applicable only to advisers that are registered or required to be registered with the Commission and thus make it inapplicable to state-registered investment advisers.

167 S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940).

168 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). The section was designed to eliminate the possibility of an investment adviser entering into a contract in which he or she "does not participate in the losses, but participates only in the profits." Investment Trusts and Investment Companies; Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 320 (1940) (statement of David Schenker, Chief Counsel of the Commission's Investment Trust Study).

169 See Securities and Exchange Commission, Investment Counsel, Investment Management, Investment Supervisor and Investment Advisory Services, H.R. Doc. 477, 76th Cong., 2nd Sess. at 30 (1939).

170 These exceptions include, among others, fulcrum fees, and performance fee arrangements of business development companies, an issuer that would be an investment company but for Investment Company Act Section 3(c)(7), and non-U.S. clients. See Advisers Act Section 205(b)(2)-(5).

171 Advisers Act Section 205(a)(2).

adviser's outstanding voting securities.[172] The legislative history indicates that the assignment provision was meant to address concerns about fiduciaries trafficking in investment advisory contracts.[173]

- Hedge and Indemnification Clauses

Advisers Act Section 215(a) voids any provision of a contract that purports to waive compliance with any provision of the Advisers Act. The Commission staff has taken the position that an adviser that includes any such provision (such as a provision disclaiming liability for ordinary negligence or a "hedge clause") in a contract that makes the client believe that he or she has given up legal rights and is foreclosed from a remedy that he or she might otherwise either have at common law or under Commission statutes is void under Advisers Act Section 215(a) and violates Advisers Act Sections 206(1) and (2).[174] The Commission staff has stated that the issue of whether an adviser that uses a hedge clause would violate the Advisers Act turns on "the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client."[175] The Commission has brought enforcement actions against advisers alleging that the advisers included hedge clauses that violated Advisers Act Sections 206(1) and (2) in client contracts.[176]

Historically, the staff expressed the concern that mandatory pre-dispute arbitration clauses in investment advisory contracts might mislead clients to believe that they have waived rights available under the Advisers Act that, by law, are not waivable.[177] The

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172 Advisers Act Section 202(a)(1). A transaction that does not result in a change of actual control or management of the adviser (e.g., a corporate reorganization or certain public mergers of the adviser's parent company) would not be deemed to be an assignment for these purposes. See Advisers Act Rule 202(a)(1)-1.

173 See, e.g., Investment Company Act of 1940 and Investment Advisers Act of 1940, S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940); and Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 253 (1940).

174 See Opinion of the General Counsel, Investment Advisers Act Release No. 58 (Apr. 10, 1951) ("While the language of these hedge clauses varies considerably, in substance they state generally that the information furnished is obtained from sources believed to be reliable but that no assurance can be given as to its accuracy. Occasionally language is added to the effect that no liability is assumed with respect to such information.").

175 See Heitman Capital Management, LLC, SEC Staff No-Action Letter (Feb. 12, 2007). Historically, the staff has taken the position that would, for example, preclude an adviser from purporting to limit its culpability to acts involving gross negligence or willful malfeasance, even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished.

176 See, e.g., In the Matter of Brian J. Sheen, Investment Advisers Act Release No. 1561 (Apr. 30, 1996) (settled order); In the Matter of Olympian Financial Services, Inc., Investment Advisers Act Release No. 659 (Jan 16, 1979) (settled order).

177 See McEldowney Financial Services, SEC Staff No-Action Letter (Oct. 17, 1986).

staff expressed the view that an investment advisory contract containing an arbitration clause should disclose that the clause does not constitute a waiver of any right provided in the Advisers Act, including the right to choose the forum, whether arbitration or adjudication, in which to seek resolution of disputes.[178] Those positions, however, largely predated Supreme Court decisions upholding pre-dispute arbitration clauses under the federal securities laws, and a subsequent federal district court opinion citing those decisions upheld the validity of a pre-dispute arbitration clause in an advisory client agreement.[179] Advisers Act Section 205(f), added by the Dodd-Frank Act, authorizes the Commission to prohibit or restrict mandatory pre-dispute arbitration provisions in client agreements, but the Commission has not proposed or adopted such a rule at this time.[180]

- Termination Penalties

The Commission has stated that an advisory client has a right at any time to terminate the advisory relationship.[181] The Commission has also brought enforcement actions regarding the right of advisory clients to receive a refund of any prepaid advisory fees that the adviser has not yet earned.[182]

Remedies

Advisory clients generally have no private right of action for damages and other monetary relief against an investment adviser under Advisers Act Section 206.[183] Rather, advisory clients have only a limited private right of action under Advisers Act Section 215 to void an investment adviser's contract and obtain restitution of fees paid.[184]

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178 Id.

179 Bakas v. Ameriprise Financial Services, Inc., 651 F. Supp. 997 (D. Minn. 2009).

180 See Advisers Act Section 205(f), providing that "[t]he Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising under the federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

181 See also Electronic Filing by Investment Advisers Proposing Amendments to Form ADV, Advisers Act Release No. 1862 (Apr. 5, 2000) (in a proposing release, the Commission stated that advisers must refund prepaid unearned advisory fees).

182 See, e.g., In the Matter of J. Baker Tuttle Corp., Initial Decision Release No. 13 (Jan. 8, 1990) and In the Matter of Monitored Assets Corp., Investment Advisers Act Release No. 1195 (Aug. 28, 1989) (settled order).

183 Transamerica, supra note 78.

184 Id.

Accordingly, clients cannot sue their adviser in federal court for damages based on a violation of the Advisers Act.[185]

A client may privately enforce claims against an investment adviser under the Exchange Act. If the client has a fraud claim in connection with the purchase or sale of a security, the client may make bring an action under Exchange Act Section 10(b) and Exchange Act Rule 10b-5. In order to be successful, the client will have to prove scienter (i.e., acting with a mental state embracing intent to deceive, manipulate or defraud), reliance and damages.[186] Rule 10b-5 has been used successfully by such clients in private actions regarding scalping, failure to disclose conflicts of interests, misrepresentation and suitability violations.[187]

Other remedies a client has against prohibited action by an investment adviser depend on applicable state law. A client could make a state common law claim that the adviser has violated its fiduciary duty,[188] was negligent[189] or committed fraud.[190] In addition to these claims, a number of states have adopted statutes regulating investment advisers that provide private rights of action for fraud.[191] All states have a securities

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185 But see Dodd-Frank Act Section 929Z(a), providing that the "Comptroller General of the United States shall conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws."

186 In 1976, the Supreme Court expressly reserved the question whether reckless behavior is sufficient for civil liability under Rule 10b-5. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194, n. 12 (1976). The Court has not subsequently addressed this question. "Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) (citing Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343 (4th Cir. 2003) (collecting cases)).

187 See, e.g., Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1970); Laird v. Integrated Resources, Inc., 897 F.2d 826 (5th Cir. 1990); Carl v. Galuska, 785 F. Supp. 1283 (N.D.Ill. 1992); and Levine v. Futransky, 636 F. Supp. 899 (N.D.Ill. 1986). See also note 236 infra discussing scalping in more detail.

188 See, e.g., Carl v. Galuska, 785 F. Supp. 1283 (N.D.Ill. 1992); Duniway v. Barton, 237 P.2d 930 (Sup. Ct. Or. 1951); Stokes v. Hensen, 217 Cal. App. 3d 187, 265 Cal. Rptr. 836 (1990); Johnson v. John Hancock Funds, 217 S.W.3d 414 (2006); State of New Mexico v. Colonial Penn Insurance Co.., 812 P.2d 777 (1991); Levin v. Kilborn, 756 A.2d 169 (2000).

189 See, e.g., Garrett v. Snedigar, 359 S.E.2d 283, 286-88 (S.C. App. 1987) and Talansky v. Schulman, 2 A.D.3d 355, 770 N.Y.S.2d 48 (2003).

190 See, e.g., Lazzaro v. Holladay, 443 N.E.2d 1347 (Mass. App. Ct. 1983) and Ohio Bureau of Workers' Compensation v. MDL Active Duration Fund, 476 F. Supp. 2d 809 (2007).

191 See Investment Adviser Industry Reform, Hearings before the House Subcommittee on Telecommunications and Finance, No. 102-128 (June 10, 1992) (statement of Lewis W. Brothers, President, North American Securities Administrators Association) at 140. See, e.g., Lehn v. Dailey, 2002 WL 449842 (Conn. Super. 2002).

statute with antifraud provisions in connection with the purchase or sale of a security. State law claims may at times provide for broader liability than federal law provides, such as aiding and abetting liability in cases of fraud.[192] State law fraud claims also do not always require a showing of scienter.[193] Clients often will not be able to make a class action lawsuit claim, however, as most such claims have been preempted by the Securities Litigation Uniform Standards Act of 1998.[194] In addition, clients may also elect to arbitrate their disputes.

2. Broker-Dealers

a) Overview of Commission and SRO Regulation

Exchange Act Section 15(a) generally requires brokers or dealers[195] that effect securities transactions, or that induce or attempt to induce the purchase or sale of securities, to register with the Commission, absent an exception or exemption. In addition, broker-dealers are required to become members of at least one SRO,[196] and

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192 See, e.g., Cal. Corp. Code §25403 (b) (extending liability to any "person that knowingly provides substantial assistance to another person in violation of any provision of this division or any rule or order thereunder").

193 See Thomas Lee Hazen, LAW OF SECURITIES REGULATION (2009) at Sec. 8.1. See, e.g., Kittilson v. Ford, 608 P.2d 264, 265 (Wash. 1980).

194 15 U.S.C. §78bb(f)(1). In Merrill Lynch, Pierce, Fenner & Smith v. Dabit, 547 U.S. 71 (2006), the Supreme Court held that state law plaintiff class action claims alleging a breach of fiduciary duty and misrepresentation or omission of a material fact in connection with the purchase or sale of a publicly traded security are preempted by the Securities Litigation Uniform Standards Act of 1998.

195 The Exchange Act generally defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others," and a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." Exchange Act Section (3)(a)(4)(A) and Section (3)(a)(5)(A).

Broker-dealers that effect transactions in securities futures products are subject to registration both with the Commission under the Exchange Act and with the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act. However, broker-dealers that are registered under the Exchange Act, may avail themselves of a notice registration procedure to register with the CFTC for the limited purpose of trading securities futures products, and such broker-dealers are exempted from many of the provisions of the Commodity Exchange Act and the rules thereunder and are not required to become a member of any registered futures association. See Commodity Exchange Act Section 4f(a)(2) and (a)(4).

196 Exchange Act Section 15(b)(8) and Exchange Act Rule 15b9-1. The Commission and the SROs conduct examinations of broker-dealers to evaluate compliance with federal securities laws and with standards of integrity, competence, and financial soundness, and may discipline broker-dealers and associated persons that fail to comply with applicable requirements. See infra Appendix A for more detailed discussion of the role of SROs, including the Commission's oversight of SROs.

(with few exceptions) the Securities Investor Protection Corporation ("SIPC").[197] Generally, all registered broker-dealers that deal with the public must become members of FINRA, a registered national securities association, and may choose to become exchange members.[198] Broker-dealers must also comply with applicable state registration and qualification requirements, as discussed in more detail in Section II.C.2 below.

Registration

Persons applying for broker-dealer registration must complete and file Form BD (Uniform Application for Broker-Dealer Registration), with the Central Registration Depository system ("CRD"), which is administered by FINRA and used by the SEC, the SROs and the states.[199] In general, Form BD requires information about the background of the applicant, its principals, controlling persons, and employees. Form BD requires information about the type of business in which the applicant proposes to engage, and the identity of the applicant's direct and indirect owners, and other control persons, as well as all affiliates engaged in the securities or investment advisory business.[200] Form BD also requires the applicant to disclose whether it or any of its control affiliates has been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity.[201] The applicant also must disclose information about branch offices, arrangements with third parties to hold records/funds, and its financial

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197 See the Securities Investor Protection Act ("SIPA"), 15 U.S.C. 78aaa et seq.

198 Exchange Act Section 15(b)(8) and Exchange Act Rule 15b9-1. FINRA was created on July 30, 2007 as a result of a merger between the National Association of Securities Dealers ("NASD"), a national securities association established to regulate broker-dealers in the over-the-counter market, and the member regulation, enforcement and arbitration functions of the New York Stock Exchange ("NYSE"). FINRA is the sole national securities association registered with the SEC under Section 15A of the Exchange Act. See Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 56145 (July 26, 2007). Accordingly, this Study focuses on FINRA's regulation, examination and enforcement with respect to member broker-dealers, and not that of the exchanges. The extent of FINRA's jurisdiction over member firms is discussed briefly in Appendix A.

FINRA is currently in the process of establishing a consolidated FINRA rulebook that will consist solely of FINRA Rules. See FINRA Rules, available at: http://www.finra.org/Industry/Regulation/FINRARules/. Until the completion of the consolidated rulebook, the FINRA rulebook consists of: (1) NASD Rules; (2) Incorporated NYSE Rules; and (3) new consolidated FINRA Rules. Id. While the NASD and FINRA rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those FINRA members that are also members of NYSE. Id. All FINRA members are subject to the FINRA By-Laws and Schedules to the By-Laws. Id. Accordingly, certain of the SRO rules discussed in this Study are FINRA rules, whereas others are NASD or NYSE rules.

199 See Exchange Act Rule 15b1-1.

200 See generally Form BD. See also Item 12, Schedules A, B and C,

201 See Item 11 and Disclosure Reporting Pages, Form BD.

capacity.[202] Once registered, a broker-dealer must keep its Form BD current by amending it promptly when changes occur.[203]

As noted above, a broker-dealer may not commence business until it satisfies the membership requirements of an SRO, which is typically FINRA for registered broker-dealers that deal with the public. Generally, the FINRA membership process includes: a membership application (including among other things, a business plan and a description of: the nature and source of capital with supporting documentation; the financial controls to be employed; the supervisory system and copies of certain procedures); a membership interview; compliance with applicable state licensing; establishment of a supervisory system; and a membership agreement.[204] FINRA can limit members to particular types of business for which they have an infrastructure in place to comply with the securities laws.[205]

FINRA's process for evaluating membership applications aims to fully evaluate relevant aspects of applicants and to identify potential weaknesses in their internal systems, thereby helping to ensure that successful applicants would be capable of conducting their business in compliance with applicable regulation.[206] In evaluating a membership application, FINRA will consider, as a whole, the applicant's business plan, information and documents submitted by the applicant, information provided during the membership interview, as well as information obtained by the staff, taking into account a variety of requirements, including among others: (1) the capability to comply with industry rules, regulations, and laws, which includes observing high standards of commercial honor and just and equitable principles of trade; (2) the capability of maintaining a level of net capital in excess of the minimum net capital requirements set

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202 Specifically, the applicant must disclose whether it or any control affiliate has been subject to a bankruptcy petition, has had a trustee appointed under SIPA, has been denied a bond, or has any unsatisfied judgments or liens. Items 11I, J and K, Form BD.

203 Exchange Act Rule 15b3-1(a).

204 See NASD Rules 1013 (New Member Application and Interview) and 1014 (Department Decision). Between January 1, 2008 and December 31, 2010, of 607 new membership applications submitted, FINRA denied 5, rejected 12 (e.g., due to applications not being substantially complete), granted registration to 22 with restrictions imposed, and granted registration without restriction to 494. Of the 607 applications, 58 were withdrawn by applicants and 16 application submissions lapsed. FINRA January Letter, supra note 10.

205 See NASD Rule 1014(b).

206 See FINRA Regulatory Notice 10-01, "Membership Application Proceedings: Proposed Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings" (Jan. 2010) ("[FINRA's Membership Application Process ("MAP")] is a fluid, probing exercise that seeks to evaluate all relevant facts and circumstances regarding each applicant. In particular, the MAP seeks to identify potential weaknesses in an applicant's supervisory, operational and financial controls. The MAP's ultimate goal is to ensure that each applicant is capable of conducting its business in compliance with applicable rules and regulations and that its business practices are consistent with just and equitable principles of trade as required by FINRA rules.").

forth in Exchange Act Rule 15c3-1 adequate to support the intended business operations on a continuing basis; (3) the existence of financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and FINRA Rules; (4) the consistency of the compliance, supervisory, operational, and internal control practices and standards with industry practices; (5) the adequacy of the supervisory system; (6) the adequacy of the recordkeeping system; (7) compliance with continuing education requirements; and (8) whether FINRA possesses information indicating that the applicant may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or FINRA rules.[207] Often this leads to business restrictions designed to foster compliance with these laws.[208] Further, a broker-dealer must provide written notice to, and receive approval from, FINRA to remove or modify business restrictions.[209] Similarly, broker-dealers must also file with FINRA an application for approval of a material change in business operations.[210]

In addition, a broker-dealer generally must register each natural person who is an associated person,[211] other than those persons whose functions are solely clerical or ministerial,[212] with one or more SROs using a Form U4 via CRD.[213] An associated person who effects or participates in effecting securities transactions also must meet qualification requirements, which include passing a securities qualification exam and complying with continuing education requirements.[214]

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207 See NASD Rule 1014(a).

208 See NASD Rule 1014(b).

209 See NASD Rule 1014(f).

210 See NASD Rule 1017.

211 The Exchange Act defines an "associated person" of a broker-dealer as any partner, officer, director, or branch manager or employee of a broker-dealer, any person performing similar functions, or any person controlling, or controlled by, or under common control with, the broker-dealer. See Exchange Act Section 3(a)(18).

212 Id.

213 See Exchange Act Section 15(b)(1) and (b)(2), and Exchange Act Rule 15b-7-1. See also NASD IM-1000-3 Failure to Register Personnel; NASD Rule 1013 ("New Member Application and Interview"), NASD Rule 1021 ("Registration Requirements"); NASD Rule 1031 ("Registration Requirements"); NASD Rule 1041 ("Registration Requirements for Assistant Representatives"). The Form U4 is used to register individuals and to disclose their employment and disciplinary histories. A registered representative must keep his or her Form U4 current by amending it promptly when changes occur.

214 See NASD Rule 1021 ("Registration Requirements"); NASD Rule 1031 ("Registration Requirements"); NASD Rule 1041 ("Registration Requirements for Assistant Representatives"); NASD Rule 1120 ("Continuing Education Requirements"). See also infra Section II.B.2 for a more detailed discussion of competency standards applicable to associated persons of broker-dealers.

Use of Finders

For purposes of broker-dealer regulation, the term "finder" is generally understood to mean an intermediary who "finds" potential investors for issuers seeking to sell securities.[215] Generally, the issuer compensates the finder for each investment by paying him or her a placement or finder's fee tied to the amount of the investment.[216]

As discussed above, receipt of transaction-based compensation in exchange for effecting transactions in securities (including soliciting investors) generally requires registration as a broker-dealer.[217] Registration is designed to ensure that persons who have a "salesman's stake" in a securities transaction are subject to the same ethical obligations governing broker-dealers and their associated persons.[218] It also provides a means to identify and protect investors against individuals who have been suspended or barred from the securities industry, or fired by firms for misconduct.

b) Regulation Related to the Provision of Personalized Investment Advice and Recommendations to Retail Customers

Under the antifraud provisions of the federal securities laws and SRO rules, including SRO rules addressing just and equitable principles of trade, broker-dealers are required to deal fairly with their customers. This fundamental obligation implies certain duties and prescribes certain conduct, which have been articulated by the Commission, the SROs, and the courts over time through rules, interpretive statements, opinions, and orders issued in enforcement actions. A broker-dealer's obligations to meet minimum business conduct requirements cannot be satisfied through disclosure to the customer: in other words, a customer cannot waive or contract away these obligations.[219]

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215 See Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 47265 at n.82 (Feb. 5, 2003), cited in Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 60 Bus. Law. 959 (May 2005).

216 Id.

217 In the Matter of Ram Capital Resources, LLC, et al., Exchange Act Release No. 60149 (June 19, 2009) (settled order) (The Commission found respondents who, among other things, solicited investors to invest in PIPE offerings, helped structure PIPE offerings, and negotiated the terms of PIPE offerings, in exchange for payments based on a percentage of the gross amount successfully invested in such offerings, acted as brokers without being registered with the Commission in violation of Exchange Act Section 15(a)).

218 See Exchange Act Rule 3a4-1 Adopting Release ("Compensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation under the Act.").

219 See Exchange Act Section 29. Dodd-Frank Act Section 929T amended Exchange Act Section 29(a) to make it applicable to any waivers relating to rules not of an exchange, but of an SRO.

While applicable statutes and regulations do not uniformly impose fiduciary obligations on a broker-dealer, broker-dealers may have a fiduciary duty under certain circumstances. This duty may arise under state common law, which varies by state. Generally, broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty similar to that of investment advisers. Broker-dealers are also subject to a variety of requirements under the federal securities laws and SRO rules that enhance their business conduct obligations, as discussed below.

Business Conduct Obligations

Broker-dealers are subject to a comprehensive set of statutory, Commission and SRO requirements that are designed to promote business conduct that, among other things, protects investors from abusive practices, including practices that are not necessarily fraudulent. These business conduct obligations cannot be waived or contracted away by customers.[220]

Duty of Fair Dealing

Broker-dealers are required to deal fairly with their customers. This duty is derived from the antifraud provisions of the federal securities laws.[221] Under the so-called "shingle" theory, by virtue of engaging in the brokerage profession (e.g., hanging out the broker-dealer's business sign, or "shingle"), a broker-dealer makes an implicit representation to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession.[222] This essential representation implies certain duties and proscribes certain conduct, which has been articulated by the Commission and courts over time through interpretive statements and enforcement actions.[223] Actions taken by the broker-dealer that are not fair to the customer must be disclosed in order to make this implied representation of fairness not misleading.[224]

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220 Id.

221 See Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, at 238 (1st Sess. 1963); In the Matters of Richard N. Cea, et al., Exchange Act Release No. 8662 at 18 (Aug. 6, 1969) ("Release 8662") (involving excessive trading and recommendations of speculative securities without a reasonable basis); In the Matter of Mac Robbins & Co. Inc., Exchange Act Release No. 6846 (July 11, 1962).

222 Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944) (although not expressly referencing the "shingle theory," held that broker-dealer was under a "special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions"; failure to disclose substantial mark-ups on OTC securities sold to unsophisticated customers thus constituted fraud).

223 See Guide to Broker-Dealer Registration, supra note 25.

224 See, e.g., Charles Hughes, supra note 222 at 437 (failure to reveal excessive mark-up was an omission to state a material fact and a fraudulent device).

Broker-dealers are also required under SRO rules to deal fairly with customers and to "observe high standards of commercial honor and just and equitable principles of trade."[225] Among other things, this obligation includes having a reasonable basis for recommendations in light of a customer's financial situation to the extent known to the broker (suitability),[226] engaging in fair and balanced communications with the public,[227] providing timely and adequate confirmation of transactions,[228] providing account statements,[229] disclosing conflicts of interest,[230] receiving fair compensation both in agency and principal transactions,[231] and giving customers the opportunity for redress of disputes through arbitration.[232] Some of these duties are discussed in more detail below.

Further, the Commission has sustained a number of FINRA disciplinary actions utilizing FINRA's authority to enforce "just and equitable principles of trade" to sanction member firms and associated persons for a broad range of unlawful or unethical activities, including those that do not implicate "securities." For example, the Commission has sustained FINRA disciplinary actions involving conduct related to

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225 See, e.g., FINRA Rule 2010 ("Standards of Commercial Honor and Principles of Trade"); NASD Interpretive Material ("IM") 2310-2 ("Fair Dealing with Customers") ("Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of [FINRA's] Rules, with particular emphasis on the requirement to deal fairly with the public.").

226 See, e.g., NASD Rule 2310 ("Recommendations to Customers (Suitability)"). A broker-dealer member is required to make reasonable efforts to obtain such information. Id.

227 See, e.g., NASD Rule 2210(d) ("Communications with the Public").

228 See, e.g., MSRB Rule G-15 (confirmation of transactions); NASD Rule 2230 ("Confirmations"). See also Exchange Act Rule 10b-10 (confirmation of transactions);

229 See, e.g., NASD Rules 2340 ("Customer Account Statements"). See also Exchange Act Rule 15c3-2 (account statements); Exchange Act Rule 10b-16 (disclosure of credit terms in margin transactions); Rule 606 of Regulation NMS (disclosure of order routing information). These disclosure requirements, together with the trade confirmation, allow a customer to keep track of his or her assets held at the broker-dealer as well as provide customers with information regarding best execution, order-handling, and the broker-dealer's own financial condition, so that the customer has the necessary information to determine whether he or she should continue to do business with the broker-dealer.

230 See, e.g., NASD Rule 2720 ("Public Offerings of Securities With Conflicts of Interest"); NASD Rule 3040 ("Private Securities Transactions of an Associated Person").

231 See, e.g., NASD Rule 2440 ("Fair Prices and Commissions"); NASD IM-2440-1)("Mark-Up Policy"); FINRA Rule 5110(c). Similarly, a broker-dealer's charges and fees for services performed must be "reasonable" and "not unfairly discriminatory between customers." See NASD Rule 2430.

232 FINRA IM 12000 ("Failure to Act Under Provisions of Code of Arbitration Procedures for Customer Disputes").

insurance applications[233] and premiums,[234] tax shelters,[235] the general entrepreneurial activity of member firms,[236] a registered representative's forgery of an executive's signature,[237] a member firm employee's improper use of a co-worker's credit card,[238] a registered representative and associated person's request and receipt of reimbursement for expenses not incurred,[239] and a registered representative's misuse of a member firm's charitable donation matching gifts program.[240]

The antifraud provisions of the Exchange Act also broadly prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[241] One provision, Exchange Act Section 15(c), prohibits any broker or dealer from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. Under this prohibition, broker-dealers are precluded from making material omissions or misrepresentations and from any act, practice, or course of business that constitutes a manipulative, deceptive, or other fraudulent device or contrivance.[242]

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233 In the Matter of the Application of Thomas E. Jackson, Exchange Act Release No. 11476 (Jun. 16, 1975).

234 In the Matter of the Application of Ernest A. Cipriani, Jr., Exchange Act Release No. 33675 (Feb. 24, 1994).

235 In the Matter of the Application of Daniel C. Adams, Exchange Act Release No. 19915 (Jun. 27, 1983).

236 In the Matter of the Application of DWS Securities, et al., Exchange Act Release No. 33193 (Nov. 12, 1993).

237 In the Matter of the Application of Mark F. Mizenko, Exchange Act Release No. 52600 (Oct. 15, 2005); In the Matter of Eliezer Gurfel, Exchange Act Release No. 41229 (Mar. 30, 1999).

238 In the Matter of the Application of Daniel D. Manoff, Exchange Act Release No. 46708 (Oct. 23, 2002).

239 In the Matter of the Application of Leonard John Ialeggio, Exchange Act Release No. 37910 (Oct. 31, 1996).

240 In the Matter of the Application of James A. Goetz, Exchange Act Release No. 39796 (Mar. 25, 1998).

241 Exchange Act Sections 10(b) and 15(c). See also Exchange Act Section 9(a). Broker-dealers may also be held liable under Section 17(a) of the Securities Act of 1933 if "in the offer or sale" of any securities, the broker-dealer (1) employs any device, scheme, or artifice to defraud, (2) obtains money or property by means of any untrue statement of a material fact or any omission to state a material fact, or (3) engages in any practice which operates as a fraud or deceit upon the purchaser. Section 17(a) requires scienter under Section 17(a)(1), but not under Section 17(a)(2) or Section 17(a)(3). See Aaron v. SEC, 446 U.S. 680 (1980).

242 See also Exchange Act Rules 10b-3, 15c1-2, and 15c1-3. These rules and Exchange Act Section 15(c) mirror Section 10(b) and Rule 10b-5 thereunder, but expressly apply to broker-dealers.

Fiduciary Duty

While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances.[243] Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty.[244] In addition, even for

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243 See Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1215 (8th Cir. 1990).

244 See, e.g., U.S. v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account"); United States v. Szur, 289 F.3d 200, 211 (2d Cir. 2002) ("Although it is true that there 'is no general fiduciary duty inherent in an ordinary broker/customer relationship,' a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.") (citations omitted); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), aff'd, 647 F.2d 165 (6th Cir. 1981) (recognizing that a broker who has de facto control over non-discretionary account generally owes customer duties of a fiduciary nature; looking to customer's sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed); Assoc. Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 212 (7th Cir. 1993) (broker is not fiduciary "with respect to accounts over which the customer has the final say"); MidAmerica Fed. Savings & Loan Ass'n v. Shearson/American Express Inc., 886 F.2d 1249, 1257 (10th Cir. 1989) (fiduciary relationship exists under Oklahoma law "where trust and confidence are placed by one person in the integrity and fidelity of another"); Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) ("Release 4048") (noting that fiduciary requirements generally are not imposed upon broker-dealers who render investment advice as an incident to their brokerage unless they have placed themselves in a position of trust and confidence); Paine Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508 (Colo. 1986) (evidence ''that a customer has placed trust and confidence in the broker'' by giving practical control of account can be ''indicative of the existence of a fiduciary relationship''); SEC v. Ridenour, 913 F.2d. 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence); Cheryl Goss Weiss, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, 23 J. Corp. L. 65 (1997).

Cf. De Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293 (2d Cir. 2002) (finding that absent "special circumstances" (i.e., circumstances that render the client dependent – a client with impaired faculties, or one who has a closer than arms-length relationship with the broker, or one who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker-dealer), a broker-dealer does not have a duty to give on-going advice between transactions in non-discretionary account, even if he volunteered advice at times; "[I]t is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments. A nondiscretionary customer by definition keeps control over the account and has full responsibility for trading decisions. On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale. The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention.") (citations omitted).

nondiscretionary accounts, broker-dealers may have fiduciary duties with respect to the limited matters entrusted to their discretion.[245]

Conflicts of Interest: Disclosure

Generally, under the antifraud provisions, a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer, which is fact intensive.[246] Where a broker-dealer processes its customer's orders, but does not recommend securities or solicit customers, then the material information that the broker-dealer is required to disclose to its customer is narrow, encompassing only the information related to the consummation of the transaction.[247] In such circumstances, the broker-dealer generally does not have to provide information regarding the security or the broker-dealer's economic self-interest in the security.[248] However, when recommending a security, a broker-dealer may be liable if it does not "give honest and complete information."[249] A broker-dealer also may be liable if it does not disclose "material adverse facts of which it is aware."[250] For example, in making

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245 See Press v. Chemical Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999) ("The cases that have recognized the fiduciary relationship as evolving simply from the broker-client relationship have limited the scope of the fiduciary duty to the narrow task of consummating the transaction requested. Simply put, 'the fiduciary obligation that arises between a broker and a customer as a matter of New York common law is limited to matters relevant to the affairs entrusted to the broker.'") (citations omitted).

246 See, e.g., Conway v. Icahn & Co., Inc., 16 F.3d 504, 510 (2d Cir. 1994) ("A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it.").

247 See, e.g., Press, 166 F.3d at 536.

248 See, e.g., Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975) (broker-dealer not required to volunteer advice where "acting only as a broker"); Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 289 (E.D. La. 1974), aff'd, 512 F.2d 484 (5th Cir. 1975) (broker-dealer that "merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer"); Walston & Co. v. Miller, 410 P.2d 658, 661 (Ariz. 1966) ("The agency relationship between customer and broker normally terminates with the execution of the order because the broker's duties, unlike those of an investment advisor or those of a manager of a discretionary account, are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.").

249 See, e.g., De Kwiatkowski , 306 F.3d 1293, 1302, supra note 244 (broker-dealer "is obliged to give honest and complete information when recommending a purchase or sale"); Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 459-61 (9th Cir. 1986) (vacating directed verdict for broker-dealer where evidence showed broker-dealer may have violated Exchange Act by failing to disclose material facts relating to risk to his unsophisticated customer and may effectively have exercised control over account); SEC v. R.A. Holman & Co., 366 F.2d 456, 458 (2d Cir. 1966) (salespersons failed to disclose that company had significant losses).

250 See, e.g., Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970); SEC v. Hasho, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); In the Matter of Richmark Capital Corp., Exchange Act Release No. 48758 (Nov. 7, 2003) (Commission opinion) ("Release 48758") ("When a securities

recommendations, courts have found broker-dealers should have disclosed: acting as a market maker for the recommended security;[251] trading as principal with respect to the recommended security;[252] revenue sharing with respect to a recommended mutual fund;[253] and "scalping" a recommended security.[254] In addition, if a broker-dealer recommends mutual funds with different classes, it must disclose the various class expenses and fees and how they will impact the expected return on investment.[255]

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dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of "adverse interests" such as "economic self interest" that could have influenced its recommendation.") (citations omitted).

251 See Chasins, 438 F.2d at 1172, supra note 250 (applying shingle theory, court found broker-dealer impliedly represented that it would disclose market making capacity).

252 If a broker-dealer recommends a security to a customer, and proposes to sell such security from the broker-dealer's own account, then the broker-dealer must disclose all material facts. See Release 4048, supra note 244 (where broker-dealer acts as principal, it must disclose cost of securities and the best price obtainable on the open market). See also Exchange Act Rule 10b-10.

253 Revenue sharing occurs when a broker-dealer is paid by a mutual fund in exchange for promoting the funds to the broker-dealer's customers. When a broker-dealer makes a recommendation of a mutual fund as to which it receives revenue sharing payments, it must disclose the revenue sharing arrangement to the customer because it is information about the potential bias of the investment advice. See In re AIG Advisor Group, 2007 WL 1213395, at 7-9 (E.D.N.Y. Apr. 25, 2007), aff'd, 390 Fed. Appx. 495 (2d Cir. 2009) (where broker-dealer received payments in form of revenue sharing and directed brokerage from mutual funds in exchange for recommending the funds to customers, omissions concerning such conflicts of interest are not immaterial as a matter of law).

254 Scalping has been defined as the practice "whereby the owner of a security recommends that security for investment and then immediately sells it at a profit upon the rise in the market price which follows the recommendation." SEC v. Hutton, 1998 WL 34078092, at 7 (D.D.C. Sept. 14, 1998). Failure to disclose such activity is a violation of Exchange Act Rule 10b-5. See Release 48758, supra note 250 (by recommending that customers purchase security without disclosing its own concurrent sales, broker-dealer omitted material information, which prevented customers from making informed investment decisions).

255 See, e.g., In the Matter of Michael Flanagan, et al., Exchange Act Release No. 4997983 (July 7, 2004) (denying application for an award of fees and expenses under the Equal Access to Justice Act), (finding that although not supported by the facts of the case, the legal theory that respondents committed fraud by failing to disclose fully the difference between Class A and Class B shares of mutual funds has substantial justification); In the Matter of J. Michael Scarborough, Exchange Act Release No. 49982 (July 8, 2004) (settled order) (respondent failed to disclose that Class A shares generally produce higher returns than Class B shares when purchased in amounts of $100,000 or more).

Merely providing the customer with a prospectus may not discharge this duty. See, e.g., In the Matter of IFG Network Securities, Inc., et al., Exchange Act Release No. 54127 (July 11, 2006) (failure to make full disclosure as to the differences in cost structures between the two classes of stock made his recommendations to invest in Class B shares misleading). But see Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598, 606-9 (6th Cir. 2005) (given that all information necessary to compare different class shares was in prospectus, alleged omissions—e.g., that over certain levels, investments in Class B shares would always result in lower returns than Class A shares—were not material).

Moreover, Exchange Act Rule 10b-10 requires a broker-dealer effecting customer transactions in securities (other than U.S. savings bonds or municipal securities[256]) to provide written notification to the customer, at or before completion of the transaction,[257] disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third-party remuneration it has received or will receive.[258] Among other things, this information allows customers to verify the terms of their transactions and provides disclosure on potential conflicts of interest.[259]

Exchange Act Rules 15c1-5 and 15c1-6 also require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or the issuer of such security.[260]

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256 MSRB Rule G-15 requires similar disclosures from municipal securities brokers and dealers.

257 While broker-dealers typically send customer confirmations the day after trade date, generally a confirmation must be sent to the customer by settlement of the transaction, which may be no later than three business days after the date of the contract to purchase or sell a security. See Securities Transaction Settlement, Exchange Act Release No. 33023 (Oct. 13, 1998); Exchange Act Rule 10b-10(d)(2) (defining "completion of the transaction" by reference to Rule 15c1-1); Rule 15c1-1(b) (generally defining "completion of the transaction" the time when: (1) a customer is required to deliver the security being sold; (ii) a customer is required to pay for the security being purchased; or (iii) a broker-dealer makes a bookkeeping entry showing a transfer of the security from the customer's account or payment by the customer of the purchase price); Rule 15c6-1 (generally requiring all contracts for the purchase or sale of a security to provide for the payment of funds or delivery of securities no later than the third business day after the date of the contract, unless otherwise expressly agreed to by the parties).

258 See Exchange Act Rule 10b-10. Compliance with Rule 10b-10 is not a safe harbor from the antifraud provisions. Rule 10b-10, Preliminary Note; see, e.g., In the Matter of Edward D. Jones & Co., L.P., Exchange Act Release No. 50910 (Dec. 22, 2004) (settled order) (failure to disclose nature and extent of conflict of interest violates Securities Act Section 17(a)(2)); In the Matter of Morgan Stanley DW, Inc., Exchange Act Release No. 48789 (Nov. 17, 2003) (settled order) (same).

259 In addition, prior to effecting a penny stock transaction, a broker-dealer generally is required to provide certain disclosures, including the aggregate amount of any compensation received by the broker-dealer in connection with such transaction; and the aggregate amount of cash compensation that any associated person of the broker-dealer has received or will receive from any source in connection with the transaction. See Exchange Act Rules 15g-4 and 15g-5.

260 With respect to Rule 15c1-5, the disclosure of control or affiliation must be made before entering into any contract for the purchase or sale of the security, and if this disclosure is not done in writing, it must be supplemented by giving or sending a written disclosure before completion of the transaction (i.e., no later than three business days after the date of the contract to purchase or sell a security). See Exchange Act Rules 15c1-1, 15c1-5, and 15c6-1. Similarly, Rule 15c1-6 requires written disclosure of the broker-dealer's interest in a security it is offering at or before the completion of the transaction. SROs require similar disclosures. See, e.g., NASD Rules 2240 and 2250; MSRB Rule G-22; NYSE Rule 312(f).

The Commission and the SROs have also adopted rules designed to address conflicts of interest that can arise when security analysts recommend equity securities in research reports and public appearances.[261] By requiring certain certifications and disclosures, these rules are intended to promote the integrity of research reports and investor confidence in those reports and analyst public appearances.

Conflicts of Interest: Prohibited or Restricted Conduct

The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. For example, FINRA rules generally prohibit a member with certain "conflicts of interest"[262] from participating in a public offering,[263] unless certain requirements are met.[264] FINRA members also may not provide gifts or gratuities to an employee of another person to influence the award of the employer's securities business.[265] FINRA rules also generally prohibit a member's registered representatives from borrowing money from or lending money to any customer, unless the firm has

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261 See Regulation Analyst Certification, or Regulation AC. See also NASD Rule 2711 and NYSE Rule 472.

262 Such a "conflict of interest" exists if, at the time of a member's participation in an entity's public offering, any of the following four conditions applies: (1) the securities are to be issued by the member; (2) the issuer controls, is controlled by or is under common control with the member or the member's associated persons; (3) at least five percent of the net offering proceeds, not including underwriting compensation, are intended to be: (i) used to reduce or retire the balance of a loan or credit facility extended by the member, its affiliates and its associated persons, in the aggregate; or (ii) otherwise directed to the member, its affiliates and associated persons, in the aggregate; or (4) as a result of the public offering and any transactions contemplated at the time of the public offering: (i) the member will be an affiliate of the issuer; (ii) the member will become publicly owned; or (iii) the issuer will become a member or form a broker-dealer subsidiary. FINRA Rule 5121(f)(5).

263 Generally, a member is considered to "participate in a public offering" for purposes of FINRA Rule 5121 if it participates "in the distribution of a public offering as an underwriter, member of the underwriting syndicate or selling group, or otherwise assist[s] in the distribution of the public offering (i.e., not when a member firm acts solely as a finder, consultant or adviser, given these capacities generally do not involve managing or distributing a public offering)." Regulatory Notice 09-49, "SEC Approves Amendments to Modernize and Simplify NASD Rule 3720 Relating to Public Offerings in Which a Member with a Conflict of Interest Participates."

264 See FINRA Rule 5121. Specifically, the rule requires prominent disclosure of the nature of the conflict in the prospectus, offering circular or similar document for the public offering, and in certain circumstances, the participation of a qualified independent underwriter. FINRA Rule 5121(a). Further, no member that has a conflict of interest may sell to a discretionary account any security with respect to which the conflict exists, unless the member has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records. FINRA Rule 5121(c).

265 See FINRA Rule 3220.

written procedures allowing such borrowing or lending arrangements and certain other conditions are met.[266]

Moreover, the Commission's Regulation M generally precludes persons having an interest in an offering (such as an underwriter or broker-dealer and other distribution participants) from engaging in specified market activities during a securities distribution.[267] These rules are intended to prevent such persons from artificially influencing or manipulating the market price for the offered security in order to facilitate a distribution.[268]

In addition, under Exchange Act Section 11(a), any member of a national securities exchange generally cannot effect transactions on such exchange for its own accounts, the accounts of its associated persons, or accounts that it or its associated persons exercise investment discretion, except under certain conditions.[269]

Exchange Act Section 11(d)(1) prohibits any person that is both a broker and a dealer from extending credit on "new issue" securities if the broker-dealer participated in the distribution of the new issue securities within the preceding 30 days. This prohibition addresses sales practice abuses deriving from conflicts of interests by preventing broker-dealers from disposing of undesirable "sticky issues" by extending easy credit terms to customers, or using easy credit terms to create the appearance of high demand for an offering to facilitate distribution.

Furthermore, Exchange Act Section 15(f) requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the firm or its associated persons from misusing material non-public information (i.e., insider trading).

Suitability

As noted above, a central aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the best interests of his customer.[270] The concept of suitability has been interpreted as an obligation under the antifraud provisions of the federal securities laws[271] and also appears in specific SRO rules.[272]

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266 See FINRA Rule 3240.

267 See Regulation M, Exchange Act Release No. 38067 (Apr. 1, 1997).

268 Id.

269 Exceptions from this general prohibition include transactions by market makers, bona fide hedge transactions, bona fide arbitrage transactions, transactions made to offset transactions made in error, transactions routed through other members, and transactions that yield to other orders. See Exchange Act Section 11(a)(1)(A)-(H).

270 See, e.g., In the Matter of the Application of Raghavan Sathianathan, Exchange Act Release No. 54722 at 21 (Nov. 8, 2006) ("NASD Conduct Rule 2310 requires that, in recommending a

- Recommendation

The determination of whether a broker-dealer has made a recommendation that triggers a suitability obligation is based on the facts and circumstances of the particular situation and, therefore, whether a recommendation has taken place is not susceptible to a bright line definition. Factors considered in determining whether a recommendation has taken place include whether the communication is a "call to action" and "reasonably could influence" the customer to enter into a particular transaction or engage in a particular trading strategy.[273] The more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation."[274]

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transaction to a customer, a registered representative 'shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.' As we have frequently stated, a broker's recommendations must be consistent with his customers' best interests.") (citations omitted). See also In the Matter of the Application of Dane S. Faber, Exchange Act Release No. 49216 at 23-24 (Feb. 10, 2004) ("Before recommending a transaction, NASD Conduct Rule 2310 requires that a registered representative have reasonable grounds for believing, on the basis of information furnished by the customer, and after reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, that the recommended transaction is not unsuitable for the customer. A broker's recommendations must be consistent with his customer's best interests, and he or she must abstain from making recommendations that are inconsistent with the customer's financial situation."); In the Matters of Powell & McGowan, Inc., Exchange Act Release No. 7302 (Apr. 24, 1964) (a broker has "an obligation not to recommend a course of action clearly contrary to the best interests of the customer").

271 See Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969). See also Municipal Securities Disclosure, Exchange Act Release No. 26100, at n. 75 (Sept. 22, 1988).

272 FINRA members' general suitability obligations are set out in NASD Rule 2310, "Recommendations to Customers (Suitability)," and NASD IMs, specifically, IM 2310-1 ("Possible Application of SEC Rules 15g-1 through 15g-9"), 2310-2 ("Fair Dealing with Customers"), and 2310-3 ("Suitability Obligations to Institutional Customers"), as applicable. As noted herein, broker-dealers have additional specific suitability obligations with respect to certain types of products or transactions.

On November 17, 2010, the Commission, through delegated authority, approved changes to FINRA's suitability and know your customer rules. The rule changes are a part of FINRA's continuing process of consolidating the NASD and NYSE rules into a consolidated FINRA rulebook. FINRA's rule changes retain the core features of the current "know your customer" and suitability obligations, while modifying both rules to strengthen and clarify them. The implementation date for the new rule will be no later than 270 days following publication of the Regulatory Notice announcing Commission approval. See FINRA Regulatory Notice 11-12 (Jan. 2011).

273 See, e.g.. Michael Frederick Siegel, 2007 NASD Discip. LEXIS 20 (May 11, 2007), aff'd, Exchange Act Release No. 58737 (Oct. 6, 2008) (finding that registered representative did not have a reasonable basis for making a recommendation); aff'd in relevant part, Siegel v. SEC, 592 F.3d 147, 150, 158 (D.C. Cir. Jan. 12, 2010); cert. denied, 130 S. Ct. 3333 (May 24, 2010)

- Suitability Obligation

The antifraud provisions of the federal securities laws and the implied obligation of fair dealing thereunder prohibit broker-dealers from, among other things, making unsuitable recommendations and require broker-dealers to investigate an issuer before recommending the issuer's securities to a customer.[275] The fair dealing obligation also requires a broker-dealer to reasonably believe that its securities recommendations are suitable for its customer in light of the customer's financial needs, objectives and circumstances (customer-specific suitability).[276]

To establish a violation of the antifraud provisions of Securities Act Section 17(a); Exchange Act Section 10(b) and Rule 10b-5 thereunder, the Commission must establish that the broker's unsuitable recommendation was a misrepresentation (or material omission) made with scienter (i.e., with a mental state embracing intent to deceive, manipulate or defraud).[277] Scienter can be knowing misconduct as well as reckless misconduct – conduct that is "at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care…to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'"[278]

(registered representative's conduct constituted a "recommendation" because it was a "call to action" that reasonably influenced investors to invest).

274 Cf. FINRA Rule 2111 (effective Oct. 7, 2011). See also FINRA Notice to Members 01-23 at n. 16 ("Although . . . a broker/dealer cannot disclaim away its suitability obligation, informing customers that generalized information provided is not based on the customer¹s particular financial situation or needs may help clarify that the information provided is not meant to be a 'recommendation' to the customer. Whether the communication is in fact a 'recommendation' still depends on the content, context, and presentation of the communication.").

275 See Hanly, 415 F.2d 589, supra note 271. See also Exchange Act Release No. 26100, supra note 271.

276 See Release 8662, supra note 221; F.J. Kaufman and Co., Exchange Act Release No. 27535 (Dec. 13, 1989) ("Release 27535").

277 See Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (holding that a breach of a fiduciary duty in connection with a securities transaction, without misrepresentation, is not a fraud for purposes of Exchange Act Section 10(b) and Rule 10b-5 thereunder). Santa Fe indicates that an unsuitable recommendation cannot serve as the basis for a fraud claim, unless the recommendation also entails an element of deception. Securities Act Section 17(a) requires scienter under Section 17(a)(1), but not under Section 17(a)(2) or Section 17(a)(3). See Aaron, 446 U.S., supra note 241.

Commission actions against broker-dealers for making unsuitable recommendations generally are brought under Securities Act Section 17(a), Exchange Act Section 10(b) and Rule l0b-5 thereunder. See, e.g., Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978); In the Matter of William C. Piontek, Exchange Act Release No. 48903 (Dec. 11, 2003) (finding violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Exchange Act Rule 10b-5 where associated person engaged in unauthorized trading and unsuitable recommendations

In contrast, FINRA and other SRO rules do not require proof of scienter to establish a suitability violation.[279] As noted above, while the suitability obligation under the federal securities laws arises from the antifraud provisions, the SRO rules are grounded in concepts of ethics, professionalism, fair dealing, and just and equitable principles of trade, which gives SROs more authority in dealing with suitability issues.[280] Obtaining a customer's consent to an unsuitable transaction does not relieve a broker-dealer of his obligation to make only suitable recommendations under the SRO rules.[281]

A violation of the suitability requirements under the antifraud provisions can also give rise to a private cause of action and civil liability under Exchange Act Section 10(b) and Exchange Act Rule 10b-5.[282] Although the SROs' suitability rules do not similarly

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and trading in customers' accounts); In the Matter of Sandra K. Simpson, et al., Exchange Act Release No. 45923 (May 14, 2002) (finding violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule l0b-5 thereunder where registered representative engaged in, among other things, unsuitable and excessive trading, churning, and abusive mutual fund sales practices); In the Matter of Stephen Stout, Exchange Act Release No. 43410 (Oct. 4, 2000) (finding violations of Securities Act Section 17(a), Exchange Act Section 10(b) and Rule l0b-5 thereunder where registered representative engaged in unsuitable and unauthorized trading and made fraudulent statements and omitted material facts).

278 See Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47 (2d Cir. 1978) (holding that scienter can be reckless conduct). See also Ernst & Ernst, 425 US 185, supra note 186. Scienter is not required under Securities Act Section 17(a)(2) and (3). See Aaron, supra note 241.

279 See, e.g., In the Matter of the Application of Jack H. Stein, Exchange Act Release No. 47335 (Feb. 10, 2003) ("Scienter is not an element for finding a violation of the NASD suitability rule."); In the Matter of John M. Reynolds, Exchange Act Release No. 30036 (Dec. 4, 1991) ("Release 30036") (scienter unnecessary to establish excessive trading under NASD rules).

280 When adopted, the SRO rules, particularly the NASD rule, were regarded primarily as ethical rules, stemming from concepts of "fair dealing" and notions of ''just and equitable principles of trade." Robert Mundheim, Professional Responsibilities of Broker-Dealers: The Suitability Doctrine, 1965 Duke L.J. 445-47; Stuart D. Root, Suitability—The Sophisticated Investor—and Modern Portfolio Management, 1991 Colum. Bus. L. Rev. 287, 290-300.

281 See, e.g., In the Matter of the Application of Clinton Hugh Holland, Jr., Exchange Act Release No. 36621 at 10 (Dec. 21, 1995) ("Even if we conclude that Bradley understood Holland's recommendations and decided to follow them, that does not relieve Holland of his obligation to make reasonable recommendations."), aff'd, 105 F.3d 665 (9th Cir. 1997) (table format); Release 30036, supra note 279 (regardless of whether customer wanted to engage in aggressive and speculative trading, representative was obligated to abstain from making recommendations that were inconsistent with the customer's financial condition); In the Matter of the Application of Eugene J. Erdos, Exchange Act Release No. 20376 at 10 (Nov. 16, 1983) (citing In the Matter of Philips & Company, Exchange Act Release 5294 at 8 (Apr. 9, 1956) ("[W]hether or not [the customer] considered the transactions in her account suitable is not the test for determining the propriety of [the registered representative's] conduct. The proper test is whether [the representative] 'fulfilled the obligation he assumed when he undertook to counsel [the customer], of making only such recommendations as would be consistent with [the customer's] financial situation and needs.'").

282 See, e.g., Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993); O'Connor v.

give rise to a private cause of action, violations of the rules can be addressed through arbitration proceedings.[283]

In general, three approaches to suitability have developed under the case law, including FINRA and Commission enforcement actions – "reasonable basis" suitability, "customer-specific" suitability, and "quantitative" suitability. Under reasonable basis suitability, a broker-dealer has an affirmative duty to have an "adequate and reasonable basis" for any security or strategy recommendation that it makes.[284] A broker-dealer, therefore, has the obligation to investigate and have adequate information about the security or strategy it is recommending. Under customer-specific suitability, a broker-dealer must make recommendations based on a customer's financial situation and needs as well as other security holdings, to the extent known.[285] This requirement is construed

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R.F. Lafferty & Co., 965 F.2d 893, 896-900 (10th Cir. 1992); Vucinich v. Paine Webber, Jackson & Curtis, Inc., 803 F.2d 454 (9th Cir. 1986).

283 Under FINRA rules, customers of broker-dealers can compel broker-dealers to arbitrate disputes. See Rule 12200 of the FINRA Code of Arbitration Procedure for Customer Disputes. See also infra discussion of arbitration and mediation of customer disputes with broker-dealers.

284 See Release 27535, supra note 276 (finding that the broker's recommendations violated suitability requirements because the broker did not have a reasonable basis for the strategy he recommended, wholly apart from any considerations relating to the particular customer's portfolio). See also Hanly, 415 F.2d at 597, supra note 271; In the Matters of Walston & Co., Exchange Act Release No. 8165 (Sept. 22, 1967) (settled order); Michael F. Siegel, 2007 NASD Discip. LEXIS 20 (2007).

See also Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations" (and FINRA Rule 2111.05 (effective Oct. 7, 2011) ("The reasonable-basis obligation requires a member or associated person 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 member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.")

285 See Release 8662, supra note 221; Release 27535, supra note 276; NASD Rule 2310 (requiring that members "have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs"); Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations"; FINRA Rule 2111.05 (effective Oct. 7, 2011) (noting that "the customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile.").

Factors relevant to analyzing customer-specific suitability include not only information about the customer (see infra Section II.b), but also characteristics of the securities and strategy recommended. Factors relating to the securities and investment strategy include, but are not limited to, the nature of the securities, the concentration of securities in the customer's portfolio,

to impose a duty of inquiry on broker-dealers to obtain relevant information from customers relating to their financial situations[286] and to keep such information current.[287] Under quantitative suitability, a broker-dealer that has actual or de facto control over a customer account must have a reasonable basis for believing that the number of recommended transactions within a certain period, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.[288] Activities such as excessive trading,[289] churning,[290]

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the use of margin, and the frequency of trading. See In the Matter of the Application of Luis Miguel Cespedes, Exchange Act Release No. 59404 (Feb. 13, 2009); In Cormac Niall Maughan, NYSE Disc. Action 2004-978 (Jun. 30, 2004); Dep't of Enforcement v. Stein, NASD Disc. Dec., 2001 WL 156957 (2001); In re Harold S. Glenzer, NYSE Disc. Action 94-57D (Oct. 13, 1994).

[286] See NASD Rule 2310.

> Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Id. See also Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations;" FINRA Rule 2111(a) (effective Oct. 7, 2011). ("A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.").

See also In the Matter of the Application of Gerald M. Greenberg, et al., Exchange Act Release 6320 (July 21, 1960) (holding that a broker cannot avoid the duty to make suitable recommendations simply by avoiding knowledge of the customer's financial situation entirely).

Under the FINRA rules, a broker-dealer's suitability obligations are different for institutional customers than for non-institutional customers. NASD IM-2310-3[FINRA Rule 2111(b)] (effective Oct. 7, 2011) sets out factors that are relevant to the scope of a broker-dealer's suitability obligations in making recommendations to an institutional customer.

[287] Exchange Act Rule 17a-3(a)(17)(i) requires, subject to certain exceptions, broker-dealers to update customer records, including investment objectives, at least every 36 months from the last recommendation.

[288] See Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations"; FINRA Rule 2111.05 (effective Oct. 7, 2011).

[289] In the Matter of the Application of Rafael Pinchas, Exchange Act Release No. 41816, at 11-12, (Sept. 1, 1999) ("Release 41816"). See also In the Matter of the Application of Clyde J. Bruff, Exchange Act Release No. 40583 (Oct. 21, 1998) (excessive trading is itself a form of unsuitability); In the Matter of the Application of Donald A. Roche, Exchange Act Release No.

and switching[291] have been found to violate the quantitative suitability obligation under the SRO suitability rules and federal antifraud provisions.

Specific disclosure, due diligence, and suitability requirements apply to certain securities products, including penny stocks,[292] options,[293] mutual fund share classes,[294] debt securities and bond funds,[295] municipal securities,[296] hedge funds,[297] direct

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38742 (June 17, 1997) ("Release 38742") (excessive trading is a type of violation of "broad" suitability rules promulgated by SROs). A broker-dealer with discretionary power over a customer's account may also violate Exchange Act Rule 15c1-7 for excessive trading in the customer's account. See Exchange Act Rule 15c1-7.

290 Churning occurs when a broker-dealer buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions. See, e.g. Release 38742, supra note 289 (quoting Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981). Churning violates the antifraud provisions of the federal securities laws. Securities Act Section 17(a), Exchange Act Section 10(b), and Rule 10b-5 thereunder. See Release 38742 at 12 (describing the elements of churning and holding that churning violates the antifraud provisions).

291 "Switching" involves transactions in which shares of a particular security are redeemed and all or part of the proceeds are used to purchase shares of another security with the primary effect of benefiting the broker rather than the customer. See, e.g., In the Matter of the Application of Scott Epstein, Exchange Act Release No. 59328 (Jan. 30, 2009), aff'd Epstein v. S.E.C., 2010 WL 4739749 (3rd Cir. 2010) (finding that a registered representative violated NASD Rules 2310(a), 2310(b), IM-2310-2, and 2110 because he did not have reasonable grounds for recommending mutual fund switches and put his own interests ahead of the interests of his customers); In the Matter of Leslie E. Rossello, Exchange Act Release No. 43650 (Dec. 1, 2000) (settled order) (finding that a registered representative violated Securities Act Section 17(a), and Exchange Act Section 10(b) and Rule 10b-5 thereunder when she induced mutual fund switches for her benefit rather than that of her customers); In the Matter of the Application of Charles E. Marland & Co., Inc., Exchange Act Release No. 11065 at 9 (Oct. 21, 1974) (recommending that mutual fund switching creates rebuttable presumption of unsuitability); In the Matter of the Application of Thomas Arthur Stewart, Exchange Act Release No. 3720 (Aug. 6, 1945) (finding that the broker violated NASD's suitability rule because it had a lack of reasonable grounds for recommending switching shares of mutual funds).

292 See, e.g., Exchange Act Rules 15g-1 through 15g-7, 15g-9 and 15c2-11(b), and Schedule 15G; FINRA Rule 2114. "Recommendations to Customers in OTC Equity Securities;" NASD IM 2310-2(b)(1), Recommending Low-priced, Speculative Securities; NASD NtM 96-32, Members Reminded to Use Best Practices When Dealing in Speculative Securities (May 1996).

293 See, e.g., Exchange Act Rule 9b-1; FINRA Rule 2360, "Options."

294 See, e.g., NASD Rule 2310; NASD Notice to Members 95-80, NASD Further Explains Members' Obligations and Responsibilities Regarding Mutual Funds Sales Practices (Sept. 26, 1995).

295 See, e.g., NASD Rule 2310; NASD Notice to Members 04-30, NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds (Apr. 2004); FINRA Regulatory Notice 08-81, FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment (Dec. 2008).

296 See, e.g., MSRB Rule G-19.

participation programs,[298] variable insurance products,[299] and non-traditional products, such as structured products and leveraged and inverse exchange-traded funds.[300] Moreover, considerations related to suitability may be raised with regard to specific types of accounts such as discretionary, day trading, or margin accounts.

Fair Prices, Commissions and Charges

SRO rules generally require broker-dealer prices for securities and compensation for services to be fair and reasonable taking into consideration all relevant circumstances.[301] Generally, this requirement prohibits a member from entering into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission that is not reasonable.[302] Recognizing that what may be "fair" (or reasonable) in one transaction could be "unfair" (or unreasonable) in another, FINRA has provided guidance on what may constitute a "fair" mark-up.[303]

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297 See, e.g., NASD Rule 2310; NASD Notice to Members 03-07, NASD Reminds Members of Obligations When Selling Hedge Funds (Feb. 2003).

298 See, e.g., FINRA Rule 2310, "Direct Participation Programs."

299 See, e.g., FINRA Rule 2330, "Members' Responsibilities Regarding Deferred Variable Annuities;" NASD Notice to Members 00-44, The NASD Reminds Members of Their Responsibilities Regarding the Sale of Variable Life Insurance (July 2000); NASD Notice to Members 99-35, The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities (May 1999).

300 See, e.g., FINRA Rule 2370, "Securities Futures"; NASD Rule 2210; FINRA Regulatory Notice 09-31, Non-Traditional ETFs [exchange-traded funds] (June 2009); NASD Notice to Members 05-59, NASD Provides Guidance Concerning the Sale of Structured Products (Sept. 2005); NASD Notice to Members 03-71, Non-Conventional Investments (Nov. 2003).

301 See NASD Rule 2440 (Fair Prices and Commissions), IM-2440-1 (Mark-Up Policy), and IM-2440-2 (Mark-Up Policy for Debt Securities). Specifically, when acting as principal, a member is required to buy from or sell to his customer a security at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit. NASD Rule 2440. Similarly, when acting as agent, the broker-dealer shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor. Id.

302 IM-2440-1 (Mark-Up Policy).

303 See IM-2440-1(c) (Mark-Up Policy). Although referred to as the "Mark-Up Policy," it applies to both principal transactions as well as agency transactions, and in the case of the latter, the commission charged the customer must be fair in light of all relevant circumstances. Id. The Mark-Up Policy incorporates what is known as the "5 Percent Policy," which states that markups or markdowns should generally not exceed 5 percent of the prevailing market price for equity securities. See IM-2440-1; Notice to Members 92-16, "NASD Policies and Procedures for Markups/Markdowns in Equity Securities" ("NTM 92-16"). This "5 Percent Policy" is a guide and not a rule: a mark-up of 5 percent or less may be unfair or unreasonable, similarly, a mark-up of

Moreover, the courts and the Commission have held that under the antifraud provisions of the federal securities laws, broker-dealers must charge prices reasonably related to the prevailing market price.[304] The Commission has consistently held that undisclosed markups of equities of more than 10% above the prevailing market price are fraudulent.[305] Markups of less than 10% may also be fraudulent in certain circumstances.[306] For example, appropriate markups on debt securities are generally much lower, with the Commission even finding markups below 4 or 5% to be excessive and fraudulent.[307]

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over 5 percent could be fair or reasonable. IM-2440-1(a). See also NTM 92-16. A determination of the "fairness" of mark-ups must be based on a consideration of all relevant factors, of which the percentage of mark-up is only one. IM-2440-1(a). Specifically, the Mark Up Policy identifies the following factors that should be considered in determining the fairness of a mark up: (1) the type of security involved; (2) the availability of the security in the market; (3) the price of the security (e.g., the percentage of mark-up or rate of commission generally increases as the price of the security decreases); (4) the amount of money involved in a transaction (e.g., a transaction involving a small amount of money may have a higher percentage of mark-up to cover the expenses of handling); (5) disclosure to the customer of the commission or mark-up; (6) the pattern of a member's mark-ups; and (7) the nature of the member's business. IM-2440-1(b); NTM 92-16.

304 See Charles Hughes, supra note 222 (broker-dealer impliedly represents that price is reasonably related to the prevailing market price); In the Matter of Duker & Duker, Exchange Act Release No. 2350 (Dec. 19, 1939). See also In the Matter of the Application of A.S. Goldmen & Co., Inc., Exchange Act Release No. 44328 (May 21, 2001) ("Release 44328") ("The prices that a broker-dealer charges retail customers for securities must be reasonably related to the prevailing market price of the security. . . . The prevailing market price typically is the current inter-dealer price, that is, the price at which dealers trade with one another. Where an integrated dealer . . . so dominates and controls the market for a security that it effectively can set wholesale prices, however, the best evidence of the security's market price is the firm's contemporaneous cost in acquiring the security, rather than the inter-dealer price. If there are no contemporaneous purchases from other dealers, purchases from retail customers may be used to determine prevailing market price, subject to an imputed markdown being added to the purchase price.") (citations omitted).

305 See Alstead, Dempsey & Co., Exchange Act Release No. 20825 (Apr. 5, 1984) at 2. See also Release 44328, supra note 304 ("We further have held that markups of more than 10 percent over the prevailing market price are evidence of scienter and have held such markups to be fraudulent.") (citations omitted).

306 See, e.g., Release 44328, supra note 304 (finding that all of the alleged markups over five percent of the integrated broker-dealer's contemporaneous cost to be excessive).

307 See, e.g., In re Anderson, 48352, 80 S.E.C. 2567 (SEC Opinion) (Aug. 15, 2003) ("We have observed 'that a significantly lower markup is customarily charged in the sale of debt securities than in transactions of the same size involving common stock." It is well-settled, for example, that markups and markdowns on municipal securities may be excessive although they are substantially below 5%. Indeed, we previously have observed that 'markups on municipal securities are often as low as one or two percent in frequently traded issues…. In 1988, we noted that the then 'common industry practice' was 'to charge a mark-up over the prevailing inter-dealer market price of between 1/32% and 3 1/2% (including minimum charges) for principal sales to customers of conventional or 'straight' Treasuries.' Markdowns generally are lower than markups.") (citations omitted). See also In the Matter of Paul George Chironis, Exchange Act

Broker-dealers are also prohibited under FINRA rules from charging unfair or unreasonable underwriting compensation in connection with the distribution of securities, and must disclose all items of underwriting compensation in the prospectus or similar document.[308] Similarly, under FINRA rules, a broker-dealer's charges and fees for services performed (including miscellaneous services such as collection of moneys due for principal, dividends, or interest; exchange or transfer of securities; appraisals, safe-keeping or custody of securities, and other services) must be "reasonable" and "not unfairly discriminatory between customers."[309] As noted above, charging an unfair commission would also violate a broker-dealer's obligation to observe just and equitable principles of trade pursuant to FINRA rules. [310]

FINRA rules also establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs.[311] These rules generally limit the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible.

Release No. 63661 (Jan. 6, 2010) (finding markups of 3.68% and markdowns of 1.92% for mortgage backed securities were excessive, and hence violated the antifraud provisions of the federal securities laws, given the highly liquid market for these securities and the minimal work required).

308 See FINRA Rule 5110(c). The following factors shall be considered in determining the currently effective guideline on the maximum amount of underwriting compensation considered to be fair and reasonable: (1) the offering proceeds; (2) the amount of risk assumed by the underwriter and related persons, which is determined by (i) whether the offering is being underwritten on a "firm commitment" or "best efforts" basis and (ii) whether the offering is an initial or secondary offering; and (3) the type of securities being offered. FINRA Rule 5110(c)(2)(D). The maximum amount of compensation that is considered fair and reasonable generally varies directly with the amount of risk to be assumed by participating members and inversely with the dollar amount of the offering proceeds. FINRA Rule 5110(c)(2)(E). This disclosure includes information about the firm but does not break out compensation to the registered representative recommending the security.

309 NASD Rule 2430. Other FINRA rules similarly prohibit discriminatory pricing. See NASD Rule 2410 ("No member shall offer any security or confirm any purchase or sale of any security, from or to any person not actually engaged in the investment banking or securities business at any price which shows a concession, discount, or other allowance, but shall offer such security and confirm such purchase or sale at a net dollar or basis price."); NASD Rule 2420 (generally providing that "[n]o member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.")

310 See NASD Rule 2010 and IM-2440-1.

311 See FINRA Rules 2310, 2320, and 5110, and NASD Rule 2830.

As noted above, Exchange Act Rule 10b-10 generally requires that a customer confirmation disclose the broker-dealer's commission, if acting as agent, or its markup, if acting as principal.

Duty of Best Execution

Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers also have a legal duty to seek to obtain best execution of customer orders.[312] The duty of best execution requires broker-dealers to seek to execute customers' trades at the most favorable terms reasonably available under the circumstances.[313] Traditionally, price has been the predominant factor in determining whether a broker-dealer satisfied its best execution obligations.[314] The Commission has stated that broker-dealers should also consider at least six additional factors: (1) the size of the order; (2) the speed of execution available on competing markets; (3) the trading characteristics of the security; (4) the availability of accurate information comparing markets and the technology to process the data; (5) the availability of access to competing markets; and (6) the cost of such access.[315]

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312 See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-270 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Exchange Act Release No. 40900 (Jan. 11, 1999) (citing Sinclair v. SEC, 444 F.2d 399 (2d. Cir. 1971); Release 4048, supra note 244. See also Order Execution Obligations, Exchange Act Release No. 37619A (Sept. 6, 1996), ("Order Handling Rules Release"). See also Regulation NMS, Exchange Act Release No. 51808 (June 9, 2005) ("Regulation NMS Release"); NASD Rule 2320 ("Best Execution and Interpositioning").

313 See Regulation NMS Release. For a discussion of the duty of best execution, see Exchange Act Release No. 37619A (Sept. 6, 1996) at 162-3. See also SEC, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994) at Study V, V-1, V-2, 1994 SEC 136, and sources cited therein.

314 The Commission has stated that "[i]n its purest form, best execution can be thought of as executing a customer's order so that the customer's total cost or proceeds are the most favorable under the circumstances." Exchange Act Release No. 34902 (Oct. 27, 1994). See also Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 ("the broker-dealer is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction").

315 See, e.g., SEC, Second Report on Bank Securities Activities, at 97-98, n.233, as reprinted in H.R. Rep. No. 145, 95 Cong., 1st Sess. 233 (Comm. Print 1977). See also NASD Rule 2320(a), which provides:

> In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used "reasonable diligence" are:
>
> (A) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;
> (B) the size and type of transaction;
> (C) the number of markets checked;

The duty of best execution applies whether a broker-dealer is acting as an agent or a principal.[316] When engaging in transactions directly with customers on a principal basis, a broker-dealer violates Exchange Act Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups (as discussed above), without disclosing the fact to the customer.[317]

Communications with the Public

Broker-dealers must ensure that their communications with the public are not misleading under the antifraud provisions of the federal securities laws.[318] In addition, FINRA has detailed rules that address broker-dealers' communications with the public[319]

(D) accessibility of the quotation; and
(E) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

316 See In the Matter of the Application of E.F. Hutton & Co., Exchange Act Release No. 25887 (July 6, 1988); Opper v. Hancock, 250 F. Supp. 688, 674-675 (S.D.N.Y.), aff'd 367 F.2d 157 (2d Cir. 1966); NASD Rule 2320(e).

317 See, e.g., Grandon v. Merrill Lynch & Co., 147 F.3d 184, 189-90 (2d Cir. 1998).

318 The antifraud provisions of the Exchange Act prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. Exchange Act Sections 10(b) and 15(c). See also Exchange Act Section 9(a). Broker-dealers may also be held liable under Securities Act Section 17(a) if "in the offer or sale" of any securities, the broker-dealer (1) employs any device, scheme, or artifice to defraud, (2) obtains money or property by means of any untrue statement of a material fact or any omission to state a material fact, or (3) engages in any practice which operates as a fraud or deceit upon the purchaser. Violations of clauses (2) or (3) do not require proof of scienter. See Aaron v. S.E.C., 446 U.S. 680 (1980).

319 Generally, with respect to FINRA rules, "communications with the public" include: (1) advertisements (i.e.. any material, other than an independently prepared reprint and institutional sales material, that is published, or used in any electronic or other public media, including any website, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings)); (2) sales literature (i.e., any written or electronic communication, other than an advertisement, independently prepared reprint, institutional sales material and correspondence, that is generally distributed or made generally available to customers or the public, including circulars, research reports, performance reports or summaries, form letters, telemarketing scripts, seminar texts, reprints (that are not independently prepared reprints) or excerpts of any other advertisement, sales literature or published article, and press releases concerning a member's products or services; (3) correspondence (i.e., any written letter or electronic mail message and any market letter distributed by a member to: (A) one or more of its existing retail customers; and (B) fewer than 25 prospective retail customers within any 30 calendar-day period); (4) institutional sales material (i.e., any communication that is distributed or made available only to institutional investors); (5) public appearances (i.e., participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity; and (6) independently prepared reprints (generally, any reprint or excerpt of any article

and specifically require broker-dealer communications to be based on principles of fair dealing and good faith and to be fair and balanced.[320] For example, pursuant to FINRA rules, communications with the public must include material facts and qualifications, must not exaggerate or include false or misleading statements, must not predict or project performance, imply that past performance will recur, or make exaggerated or unwarranted claims, opinions or forecasts.[321] FINRA rules also establish disclosure requirements for advertisements and sales literature.[322]

In certain circumstances, FINRA rules require that communications with the public be approved by a registered principal of the broker-dealer before distribution to the public. Generally, a registered principal must approve each advertisement, item of sales literature and independently prepared reprint prior to the earlier of its use or filing with FINRA.[323]

Moreover, FINRA rules require that certain broker-dealer communications with the public must be filed with FINRA for approval.[324] Broker-dealers are generally required to obtain FINRA pre-approval for advertisements for their first year of advertising.[325] Additionally, FINRA must preapprove certain broker-dealer communications with the public if they relate to: (1) registered investment companies (including mutual funds, variable contracts, continuously offered closed-end funds and unit investment trusts) that include or incorporate performance rankings or performance comparisons; (2) collateralized mortgage obligations; (3) security futures; or (4) bond mutual funds that include bond mutual fund volatility ratings.[326] Further, if after reviewing a member's advertising or sales literature FINRA determines that the member has departed from the standards of Rule 2210, FINRA may require the member to file all, or a portion of its, advertising or sales literature with FINRA for a period of time to be determined by FINRA.[327]

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issued by a publisher and any report concerning an investment company registered under the Investment Company Act, subject to certain conditions). NASD Rule 2210(a).

320 NASD Rule 2210(d)(1)(A).

321 See NASD Rule 2210(d)(1).

322 NASD Rule 2210(d)(2).

323 NASD Rule 2210(b)(1)(A).

324 NASD Rule 2210(c)(8) exempts from the rule's filing requirements and spot-check procedures discussed herein institutional sales material (i.e., any communication that is distributed or made available only to institutional investors).

325 See NASD Rule 2210(c)(5)(A).

326 NASD Rule 2210(c)(4).

327 See NASD Rule 2210(c)(5)(B).

Other communications, while not subject to FINRA preapproval, must be filed with FINRA. Specifically, within 10 business days of first use or publication, a broker-dealer generally must file the following with FINRA: (1) advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts, continuously offered closed-end funds, and unit investment trusts); (2) advertisements and sales literature concerning public direct participation programs; (3) advertisements concerning government securities; and (4) any template for written reports produced by, or advertisements and sales literature concerning, an investment analysis tool.[328] Furthermore, FINRA may subject a member's written and electronic communications with the public to a spot-check procedure.[329]

In 2008, FINRA reviewed more than 99,000 communications, including through spot checks, and completed 476 investigations involving 2,378 separate communications.[330]

Pursuant to Exchange Act rules, all communications with the public must be maintained in the broker-dealer's records.[331]

Additional Substantive Requirements

Broker-dealers are also subject to a variety of additional requirements under the federal securities laws and SRO rules that enhance the business conduct obligations discussed above. The following is a brief overview of some of these requirements.

Books and Records

Commission and SRO books and records rules help to ensure that regulators can access information so that examiners can evaluate the financial and operational condition of the firm, including examining the broker-dealer for compliance with financial responsibility, sales practice and other obligations. Exchange Act Section 17(a)(1) requires registered broker-dealers to make and keep for prescribed periods such records as the Commission deems "necessary or appropriate in the public interest, for the protection of investors." The books and records requirements for broker-dealers are comprehensive.

Exchange Act Rules 17a-3 and 17a-4 specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents must be kept. Specifically, Exchange Act Rule 17a-3 delineates the minimum

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328 NASD Rule 2210(c)(2).

329 See NASD Rule 2210(c)(7).

330 See Rick Ketchum, Chairman & Chief Executive Officer, FINRA, Testimony Before the Committee on Financial Services U.S. House of Representatives (Oct. 6, 2009), available at: http://www.finra.org/Newsroom/Speeches/Ketchum/P120108. See also FINRA Statistics, available at http://www.finra.org/Newsroom/Statistics/index.htm.

331 Exchange Act Rule 17a-4(b)(4).

books and records a broker-dealer should maintain, including approximately 22 specific types of records. For example, Rule 17a-3 requires broker-dealers to make and keep current customer account records, copies of customer confirmations and records of customer complaints.

Exchange Act Rule 17a-4 specifies the manner in which the records required to be made under Rule 17a-3 must be maintained, and also identifies additional records that must be maintained for prescribed time periods. For example, Rule 17a-4 requires a broker-dealer to maintain all communications received and copies of all communications sent that relate to the broker-dealer's "business as such" for three years (the first two years in an easily accessible place), and certain other records must be retained for longer periods.

Financial Responsibility

Broker-dealers must meet certain financial responsibility requirements, including maintaining minimum amounts of liquid assets ("net capital"); safeguarding customer funds and securities held by the broker as required by the "customer protection rule"; complying with customer margin requirements; filing periodic reports, including quarterly and annual financial statements; notifying the Commission and the appropriate SRO of operational or financial difficulties, and in some cases filing reports regarding those problems; and maintaining certain books and records.[332] The principal purposes of the broker-dealer net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from SIPC. The minimum capital requirement changes depending on the nature and amount of business conducted by the broker-dealer. If a broker-dealer falls below its minimum net capital requirement, it must immediately cease conducting a securities business. The vast majority of customer accounts are held by broker-dealers with capital in excess of $100 million, and in some cases, several billion dollars. As noted above, broker-dealers (with few exceptions) are also required to be members of SIPC which protects their customers from loss of their cash and securities up to specified limits if the broker-dealer becomes insolvent.[333] Generally, all broker-

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[332] See, e.g., Exchange Act Rules 15c3-1 (the "net capital rule") and 15c3-3 (the "customer protection rule"); Exchange Act Section 7(a) (prohibiting broker-dealers from, directly or indirectly, extending or maintaining credit or arranging for the extension or maintenance to or for any customer in contravention of the rules and regulations prescribed by the Board of Governors of the Federal Reserve System ("FRB") and without collateral or on any collateral other than in accordance with the rules promulgated by the FRB); 12 CFR 220.1–220.12 (FRB's Regulation T); Incorporated Rule NYSE Rule 431 (Margin Requirements); NASD Rule 2520 ("Margin Requirements"); Exchange Act Rules 17a-3, 17a-4, 17a-5, 17a-11, and 17a-13.

[333] The SIPC trustee will first return to customers securities registered in a customer's name. The broker-dealer's remaining customer assets are then divided on a pro rata basis with funds shared in proportion to the size of each customer's claim. If sufficient funds are not available in the broker-dealer's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $250,000 for cash claims. SIPA does not protect against market losses in the value of securities.

dealers that are required to do business with the public are also required to obtain a fidelity bond from a reputable insurance company.[334]

Supervision and Compliance

The Exchange Act authorizes the Commission to sanction a broker-dealer or any associated person that fails to reasonably supervise another person subject to the firm's or the person's supervision that commits a violation of the federal securities laws.[335] The Exchange Act provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe those procedures and systems are not being complied with.[336] The Commission's policy regarding failure to supervise is well-established and emphasizes that it is the responsibility of broker-dealers and their supervisory personnel to supervise their employees.[337] Failure to supervise liability is a critical component of the federal regulatory scheme for broker-dealers.[338]

Generally, broker-dealers must establish policies and procedures (and systems for implementing and monitoring compliance with such procedures) that are reasonably designed to prevent and detect violations of the federal securities laws and regulations, as well as applicable SRO rules.[339] However, establishing policies and procedures alone is not sufficient to discharge supervisory responsibility.[340] It is also necessary to implement measures to monitor compliance with those policies and procedures.[341] Specifically, a

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It protects the value of the securities held by the broker-dealer as of the time that a SIPC trustee is appointed

334 NASD Rule 3020, "Fidelity Bonds."

335 Exchange Act Sections 15(b)(4)(E) and (b)(6)(A).

336 Exchange Act Sections 15(b)(4)(E) and (b)(6)(A).

337 See In the Matter of John H. Gutfreund, et al., Exchange Act Release No. 31554 (settled order) (report pursuant to Exchange Act Section 21(a)); In the Matter of Donald T. Sheldon, Exchange Act Release No. 31475 (Nov. 18, 1992) ("Release 31475").

338 Release 31475, supra note 337.

339 See, e.g., Exchange Act Sections 15(b)(4)(E) and (b)(6)(A); In the Matter of Bearcat, Inc., Exchange Act Release No. 49375 (Mar. 8, 2004); In re Kirkpatrick, Pettis, Smith, Polican Inc., et al., Exchange Act Release No. 48748 (Nov. 5, 2003) (settled order); NASD Rule 3010 and 3012; NASD Notice to Members 99-45, NASD Provides Guidance on Supervisory Responsibilities (June 1999); NASD Notice to Members 98-38, NASD Reminds Members of Supervisory and Inspection Obligations (May 1998); NASD Notice to Members 86-65, Compliance with the NASD Rules of Fair Practice (Sept. 1986). See also Incorporated NYSE Rule 342.

340 See In the Matter of John A. Carley, et al., Securities Act Release No. 8888 (Jan. 31, 2008).

341 See In the Matter of the Application of Stuart K. Patrick, Exchange Act Release No. 32314 (May 17, 1993); In the Matter of the Application of Richard F. Kresge, Exchange Act Release No. 55988 (June 29, 2007).

broker-dealer must have an appropriate system of follow-up and review if red flags are detected.

In addition to satisfying supervisory obligations mandated by the Exchange Act, NASD Rule 3010 requires firms to establish and maintain a supervisory system for their business activities and to supervise the activities of their registered representatives, principals and other associated persons for purposes of achieving compliance with applicable securities laws and NASD rules.[342] This supervisory system must include, among other things, the establishment, maintenance and enforcement of policies and procedures reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules.[343] Explicit delineation of the supervisory hierarchy, including the designation of a direct supervisor for each representative and the assignment of specific supervisory responsibilities to the supervisor, is also a required part of a broker-dealer's supervisory system.[344] The broker-dealer must also establish policies and procedures for identifying circumstances that warrant additional or heightened supervision (e.g., a registered representative with a disciplinary history in a remote office) and providing for such additional or heightened supervision.[345] NASD Rule 3010 further requires a firm to conduct at least an annual review of the businesses in which it engages, and also details mandatory inspection cycles that each member must have in place for its supervisory branch offices, non-supervisory branch offices, and unregistered locations.[346]

In addition, NASD Rule 3012 requires each member firm to (i) have a system of supervisory control policies and procedures to test and verify that the member's supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and NASD rules, and (ii) where necessary, amend or create additional supervisory procedures.[347]

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342 NASD Rule 3010 has not yet transferred to the FINRA rulebook.

343 NASD Rule 3010(a)(1) and (b)(1).

344 See NASD Rule 3010(a).

345 See NASD Rule 3010(b)(2) and (c)(3); NASD IM 3010-1 ("Standards for Reasonable Review"); 98-38; NASD Notice to Members 98-38, "NASD Reminds Members Of Supervisory And Inspection Obligations" (May 1998). See also NASD Rule 3012(a)(2)(C).

346 Specifically, firms must inspect: (1) at least annually, every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations; (2) at least every three years, every branch office that does not supervise one or more non-branch locations; and (3) on a regular periodic schedule, every non-branch location. NASD Rule 3010(c).

347 NASD Rule 3012 also requires the designation and identification of one or more principals who shall establish, maintain, and enforce a system of such supervisory control policies and procedures. At least annually, the designated principal(s) must submit to senior management a report detailing the member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

Furthermore, FINRA rules require broker-dealers to designate one or more principals to serve as CCO.[348] At least annually, the CCO must meet with the broker-dealer's chief executive officer ("CEO") to discuss the compliance program, and the CEO must certify that, among other things, the firm has in place processes to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations.[349]

- Outside Business Activities and Private Securities Transactions

FINRA rules also generally require supervision of outside business activities and private securities transactions by associated persons of members.[350] Specifically, FINRA Rule 3270 prohibits any registered person from being an employee, independent contractor, sole proprietor, officer, director or partner of another person, or being compensated, or having the reasonable expectation of compensation, from another person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the firm in the form specified by the firm.

FINRA Rule 3270 requires that, upon receipt of a written notice, a firm must consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the firm and/or the firm's customers or (2) be viewed by customers or the public as part of the firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Additionally, based on the firm's review of such factors, the firm must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity.[351] A firm also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of NASD Rule 3040.[352]

NASD Rule 3040 requires an associated person to provide notice of participation in private securities transactions to the member firms with which he is associated. If the

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348 FINRA Rule 3130(a).

349 See FINRA Rule 3130(b) and (c).

350 See FINRA Rule 3270; NASD Rule 3040. In addition, private securities transactions of an associated person may be subject to an analysis under Exchange Act Section 10(b) and Rule 10b-5, as well as the broker-dealer supervisory provisions of Section 15(f) and Section 15(b)(4)(E), and other relevant statutory or regulatory provisions.

351 FINRA Rule 3270.

352 FINRA Rule 3270.

associated person has received or may receive selling compensation for that transaction, the member firm may approve or disapprove the associated person's participation in the transaction.[353] It has long been established that NASD Rule 3040 encompasses investment advisory activity to the extent the associated person participates in the execution of a securities transaction.[354] For example, according to FINRA, preparation of a financial plan away from a firm would be an outside business activity subject to FINRA Rule 3270, and not a private securities transaction subject to NASD Rule 3040.[355]

Employee Competency and Regulatory Standards

As part of the broker-dealer registration process, associated persons of an applicant who effect or participate in effecting securities transactions must satisfy certain qualification requirements set forth in FINRA rules, which include passing one or more examinations administered by FINRA to demonstrate competence in the areas in which they will work.[356]

Pursuant to FINRA rules, registered persons are also required to comply with continuing education requirements.[357] The continuing education program consists of two parts—a regulatory element and a firm element—that have been approved by the SEC and that focus on current compliance, regulatory, ethical and sales-practice standards.[358] FINRA administers the industry-wide regulatory element of the program in the second year of registration and every three years thereafter.[359] Furthermore, each broker-dealer is required to implement an ongoing in-house education program to keep employees up to date on job and product-related subjects.[360]

Individuals who have engaged in specified "bad acts" are subject to a "statutory disqualification" and must undergo a regulatory review before being permitted to become associated with a broker-dealer or being granted membership in an SRO.[361] This

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353 NASD Rule 3040(c).

354 See NASD Notice to Members 94-44, Board Approves Clarification On Applicability Of Article III, Section 40 Of Rules Of Fair Practice To Investment Advisory Activities Of Registered Representatives.

355 See NASD Notice to Members 96-33, NASD Clarifies Rules Governing RR/IAs.

356 See generally NASD Rule 1000 Series. See also Exchange Act Section 15A(g)(3)(B)(i).

357 NASD 1120. See also Exchange Act Section 15A(g)(3)(B)(i).

358 NASD Rule 1120.

359 NASD Rule 1120(a)(1).

360 NASD Rule 1120(b).

361 See Exchange Act Section 3(a)(39). A wide range of disciplinary events subjects a person to statutory disqualification, including convictions for any felony or certain enumerated misdemeanors within the last ten years; temporary or permanent injunctions from violating the

process, which encompasses reviews first by the appropriate SRO and subsequently by the Commission,[362] is designed to subject individuals who present a higher risk of doing harm to investors to heightened scrutiny prior to allowing them to enter the business and to ensure that such individuals are subject to appropriate safeguards (e.g., enhanced supervision or limitations on the scope of their activities) if they are permitted to enter the business.

Customer Complaints and Disclosure of Disciplinary Information

Broker-dealers must maintain (1) a record for each written customer complaint received regarding an associated person, including the disposition of the complaint, and (2) a record indicating that each customer has been provided with a notice with the address and telephone number to which complaints may be directed.[363] SRO rules require broker-dealers to document and respond to all customer complaints.[364] Pursuant to SRO rules, broker-dealers also must report to the SROs certain specified events related to customer complaints, as well as statistical and summary information on customer complaints.[365] The information reported by broker-dealers provides the SROs with important regulatory information that assists with the timely identification of potential sales practice and operational problems.

In addition, Forms BD and U4, are also used to disclose certain disciplinary and complaint information regarding the applicant.[366] This information is made publicly available through FINRA's BrokerCheck system.

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securities laws issued by a court of competent jurisdiction; or bars from association with a broker-dealer by the Commission, the CFTC, or an SRO.

362 Those persons who are subject to statutory disqualification, but wish to enter or re-enter the industry, must apply to the SRO under procedures adopted pursuant to the Exchange Act. If the SRO determines that it would be in the public interest to permit the individual to work as proposed with one of its members, it formally notifies the Commission. See Exchange Act Sections 6(c)(2) and 15A(g)(2) and Exchange Act Rule 19h-1. The Commission then has the opportunity to review the SRO's determination, and if necessary, to direct that the SRO not permit the proposed association.

363 Exchange Act Rule 17a-3(a)(18).

364 See e.g., Incorporated NYSE Rule 401A.

365 See NASD Rule 3070; Incorporated NYSE Rule 351(d). On November 5, 2010, the Commission, through delegated authority, approved changes to adopt NASD Rule 3070 as FINRA Rule 4530 (Reporting Requirements) in the consolidated FINRA rulebook, subject to certain amendments, and to delete paragraphs (a) through (d) of Incorporated NYSE Rule 351 (Reporting Requirements) and Incorporated NYSE Rules 351.10 and 351.13. See Exchange Act Release No. 34–63260 (Nov. 5, 2010).

366 Broker-dealers and registered representatives must keep their respective Form BD or Form U4 current by amending it promptly when changes occur. See Form BD Instructions; Form U4 Instructions.

For example, Form BD requires the applicant to disclose whether it or any of its control affiliates has been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity. Certain of these disciplinary events must be disclosed regardless of when they occurred,[367] whereas others are required to be disclosed if they occurred within the previous ten years.[368] The applicant must disclose any of the disciplinary events specified on Form BD.[369]

Form U4 requires disclosure of disciplinary actions[370] and other sanctions that are deemed "statutory disqualifications."[371] These disclosures must be made regardless of when they have occurred.[372] Form U4 also requires disclosure of certain customer-initiated complaints, arbitration, and civil litigation claims.[373] For example, with respect to customer complaints, Form U4 requires disclosure of settled customer complaints involving sales practice violations (subject to a minimum settlement amount), customer complaints involving sales practice violations made within the past 24 months (subject to a minimum on damages sought), and complaints alleging involvement in forgery, theft,

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367 Form BD provides a comprehensive listing of the disciplinary events that must be disclosed regardless of when they occurred. See Items 11A through 11H of Form BD. Among other things, such events generally include a finding by: (1) a regulatory authority or an SRO that the applicant or control affiliate has made a false statement or omission; or (2) a regulatory authority, an SRO or a court that the applicant or control affiliate was involved in a violation of investment-related statutes, regulations, or SRO rules, as applicable. See Items 11C through 11E, and 11H of Form BD. "Involved" is defined as "doing an act or aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act." See Form BD, "Explanation of Terms."

368 Form BD provides a comprehensive listing of such events. See Items 11A through 11H of Form BD. This listing generally includes whether the applicant or a control affiliate have been convicted of, pled guilty or *nolo contendere* to, or charged with any felony or to a misdemeanor involving investments or an investment-related business, any fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or conspiracy to commit any of these misdemeanors. See Items 11B of Form BD.

369 Cf. Item 9 of Part 2A of Form ADV (explaining four factors that an adviser should consider in determining whether a disciplinary event is material); Advisers Act Rule 204-2(a)(14)(iii) (Requiring an investment adviser to maintain as part of its books and records a memorandum describing any legal or disciplinary event listed in Item 9 of Part 2A and presumed to be material, involving the investment adviser or any of its supervised persons, and that is not disclosed. The memorandum must explain the investment adviser's determination that the presumption of materiality is overcome, and must discuss the factors described in Item 9 of Part 2A of Form ADV.)

370 Generally, the disciplinary actions that must be disclosed on Form U4 mirror those required to be disclosed by a broker-dealer applicant on Form BD. See Item 14A through Item 14H of Form U4.

371 Exchange Act Section 3(a)(39) defines a "statutory disqualification."

372 See Item 14A through Item 14J of Form U4.

373 See Item 14I of Form U4.

misappropriation or conversion of funds or securities.[374] Moreover, the disclosures relating to arbitration and civil litigation claims include pending, resolved and settled claims (subject to applicable minimum thresholds).[375] Certain of these customer complaints and claims must be disclosed regardless of when they occurred, whereas others need only be disclosed if they occurred within the previous 24 months.[376]

Remedies

- Arbitration and Mediation

SRO rules require members and their associated persons to arbitrate any eligible dispute upon demand by a customer, even in the absence of a pre-dispute arbitration agreement.[377] SRO rules do not require customers to arbitrate these disputes, but as a practical matter, most investors who have brokerage accounts have signed an agreement, as a condition to opening the account, which requires them to resolve any disputes with their broker through arbitration rather than the courts.[378] If no arbitration agreement is in place, and the customer does not elect arbitration, firms are subject to redress in court by default.

The Commission is authorized to oversee the arbitration programs of the SROs, including FINRA, through inspections of the SRO facilities[379] and review of SRO

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374 See Item 14I of Form U4.

375 See Item 14I of Form U4.

376 See Item 14A through Item 14I of Form U4.

377 See, e.g., Rule 12200 of the FINRA Code of Arbitration Procedure for Customer Disputes.

378 In 1987, the U.S. Supreme Court decided Shearson/American Express, Inc. v. McMahon, 482 U.S. 222 (1987), which determined that customers who sign pre-dispute arbitration agreements with their brokers may be compelled to arbitrate claims arising under the Exchange Act. The Supreme Court has also decided that pre-dispute arbitration agreements are binding with respect to investors' claims under the Securities Act of 1933. Rodriquez de Quijas v. Shearson/American Express, 490 U.S. 477 (1989). The Supreme Court upheld the primacy of arbitration agreements with respect to state law claims in Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985). The standard arbitration agreement covers all disputes arising under federal law, state law, and SRO rules.

Dodd-Frank Act Section 921 gives the Commission discretionary authority to limit agreements providing for mandatory arbitration of any future dispute between the parties. The authority covers broker-dealers, municipal securities dealers, and investment advisers.

379 The staff conducts inspections to identify areas where procedures should be strengthened, and to encourage remedial steps either through changes in administration or through the development of rule changes. The staff also evaluates whether the SROs are following and enforcing applicable rules. Typically, the staff briefs the Commission on its findings and is authorized by the Commission to send to the SROs the staff's views contained in the inspection reports. See Appendix A, Section I.B for further discussion of the Commission's oversight of FINRA.

arbitration rules pursuant to Exchange Act Section 19.[380] Exchange Act 15(o), added by the Dodd-Frank Act, authorizes the Commission to prohibit or restrict mandatory pre-dispute arbitration provision in customer agreements, but to date the Commission has not proposed or adopted such a rule.[381]

In arbitration, customers may pursue alleged violations of Exchange Act Section 10(b) and Rule 10b-5 with respect to disclosure, customer communications (including advertisements), or alleged suitability violations, as well as alleged violations of other SRO rules. Customers may also assert a claim that does not constitute a private right of action under the federal securities laws or SRO rules. Many claimants allege violations of SRO rules, either as a separate cause of action or as part of another cause of action such as negligence, breach of fiduciary duty, or failure to supervise.[382] By way of example, in 2009, 7,137 arbitration cases were filed with FINRA and 4,571 cases were closed.[383] The FINRA arbitration cases served in 2009 involved the following types of controversies, in order of frequency: breach of fiduciary duty (4,206); misrepresentation (3,408); negligence (3,405); breach of contract (2,802); failure to supervise (2,691); unsuitability (2,473); omission of facts (2,453); unauthorized trading (478); churning (306); and margin calls (128).[384]

Pursuant to FINRA rules, broker-dealers are generally required to pay monetary awards within 30 days of receipt of the award.[385] FINRA may suspend or cancel the membership of any member, or suspend any associated or formerly associated person from association with any member, for failure to comply with an arbitration award or

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380 Exchange Act Section 19(b) requires the Commission to review and approve most SRO rules – including arbitration rules – before they can be put into effect. See Appendix A for further discussion of the Commission's oversight of FINRA's rulemaking.

381 See Exchange Act 15(o), providing that "[t]he Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.''

382 Arbitration panels are not bound by precedent, and they are not required to write or publish opinions. See FINRA Rule 12904(g); Exchange Act Release No. 59358, n. 13 (February 4, 2009). See also Pace Law School Investor Rights Clinic, Investor's Guide to Securities Industry Disputes at 11, 23 available at: http://www.finra.org/web/groups/foundation/@foundation/documents/foundation/p119054.pdf.

383 See FINRA Dispute Resolution Statistics, available at: http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm.

384 See FINRA Dispute Resolution Statistics, available at: http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm. Note that each case filed can be coded to contain up to four controversy types. Therefore, the numbers reflected in this listing cannot be totaled to determine the number of cases served in a year. Id.

385 See FINRA Rule 12904(j).

with a written and executed settlement agreement obtained in connection with an arbitration or mediation.[386] Moreover, failure to honor an award, or comply with a written and executed settlement agreement, obtained in connection with an arbitration proceeding may be deemed inconsistent with just and equitable principles of trade and thus expose the broker-dealer to sanctions for violating FINRA Rule 2010.[387]

Customers may also pursue the resolution of a securities dispute through mediation. Pursuant to FINRA rules, mediation is conducted on a voluntary basis and is not binding on the parties.[388] Between January and October 2010, 732 FINRA mediation cases were in agreement and 750 cases were closed.[389]

The Commission's oversight of securities arbitration is directed at ensuring that the process is, among other things, designed to promote just and equitable principles of trade and to protect investors and the public interest.[390]

- Other Customer Remedies

If there is no valid pre-dispute arbitration agreement,[391] customers may bring actions against broker-dealers in court in connection with disclosure, customer communications (including advertisements), or suitability violations under Exchange Act Section 10(b) and Rule 10b-5. Courts have consistently recognized an implied private right of action under these provisions.[392] Customers also may bring actions against broker-dealers for claims arising under state law, including those arising from breaches of fiduciary duties under state law.[393]

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386 See NASD By-Laws, Art. VI, Sec. 3(b); NASD By-Laws, Art. V., Sec. 4(b); NASD Notice to Members 04-57, "NASD Extends Jurisdiction to Suspend Formerly Associated Persons Who Fail to Pay Arbitration Awards" (Aug. 2004).

387 See FINRA IM-12000.

388 See FINRA Manual, Code of Mediation Procedure, Rule 14000 et seq.

389 See FINRA Dispute Resolution Statistics, available at: http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm.

390 See Exchange Act Section 6(b)(5) (with respect to exchange rules); Exchange Act Section 15A(b)(6) (with respect to securities association rules).

391 Most investors who have brokerage accounts have signed a pre-dispute arbitration agreement as a condition to opening the account. See supra note 378 and accompanying text.

392 See, e.g., Ernst, supra note 186; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730, 744 (1975); Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 13, n. 9 (1971).

393 See supra note 245.

In addition, Exchange Act Sections 9(e), 16(b), and 18 provide express civil liability for manipulation of securities registered on exchanges, short-term insider trading and false filings.

The Private Securities Litigation Reform Act of 1995 ("PSLRA"), which was enacted to address perceived abuses in the securities litigation process, among other things, has imposed enhanced pleading requirements for fraud actions under the securities laws.[394]

Courts are divided over whether SRO rules give rise to private rights of action in court.[395] A violation of an SRO rule may, however, be relevant in a dispute in determining whether a broker-dealer acted reasonably and in accord with the prevailing standards of the industry,[396] or whether the broker has committed fraud.[397] In addition, the violation of an SRO rule may be used as evidence of liability in an action claiming under negligence or breach of fiduciary duty.[398]

Customers also may have contract rescission rights in certain circumstances. Exchange Act Section 29(b) provides, in pertinent part, that every contract made in violation of the Exchange Act or of any rule or regulation adopted under the Exchange Act (with certain exceptions) shall be void.

The Securities Act of 1933 ("Securities Act") also provides a venue for civil liability and rescission rights. For example, pursuant to Securities Act Section 12(a)(1) any person that "[o]ffers or sells a security in violation of Section 5 (i.e., offers or sells unregistered securities without an available exemption) is liable to his or her purchaser for rescission or damages (subject to the loss causation provisions found in Section 12(b)). Similarly, Securities Act Section 12(a)(2) generally provides that any person who offers or sells a security, by "means of a prospectus or oral communication" that includes a material misstatement or omission, is liable to the purchaser for rescission or damages (subject to the loss causation provisions found in Securities Act Section 12(b)).

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394 Public Law No: 104-67, 109 Stat. 737.

395 See, e.g., Hempel v. Blunt, Ellis & Loewi, Inc., 123 F.R.D. 313, 318-319 (E.D. Wis. 1988) (holding that, where the rule was designed for the direct protection of investors, and conduct was "tantamount to fraud," SRO suitability rules gave rise to private right of action). But see Gilman v. Shearson/American Express, Inc., 577 F. Supp. 492 (D.N.H. 1983) (denying private right of action under NYSE and NASD suitability rules).

396 See Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir.) reh'g denied, 642 F.2d 1210 (5th Cir. 1981).

397 See Hoxworth v. Blinder, Robinson & Co., Inc., 903 F.2d 186, 200 (3d Cir. 1990).

398 See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 697 F. Supp. 1224, 1227 (D.D.C. 1988); Rupert v. Clayton Brokerage Co., 737 P.2d 1106, 1110-1112 (Colo. 1987).

C. State and Other Regulation of Investment Advisers and Broker-Dealers

In addition to the federal securities laws and SRO rules, state and other regulation may also apply to the provision of investment advice and recommendations about securities to retail customers.[399]

1. Investment Advisers

a) Overview of State Regulation Intended to Protect Clients

The states regulate the activities of investment advisers in a number of ways. First, as previously discussed, under Advisers Act Section 203A, most small advisers are prohibited from registering with the Commission and are registered and regulated by state regulators.[400] Second, states may impose registration, licensing or qualification requirements on "investment adviser representatives" who have a place of business within the state.[401] States also retain authority over Commission-registered investment advisers under state investment adviser statutes to investigate and bring enforcement actions with respect to fraud or deceit against an investment adviser and an investment adviser's associated persons, which is discussed in more detail below. Finally, as described further below, the states are responsible for examining state-registered investment advisers and their investment adviser representatives.[402]

State Registration and Regulation of Investment Advisers

As stated previously, Advisers Act Section 203A prohibits investment advisers with less than $25 million of assets under management from registering under the Advisers Act. The Dodd-Frank Act raised this to $100 million as of July 21, 2011. The Dodd-Frank Act also amended Section 203A to provide that investment advisers must also be subject to inspection and examination by their home state).[403]

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399 The sections relating to state regulation provide a general overview of investment adviser and broker-dealer regulation, as applicable, in the 50 U.S. states and the District of Columbia (each a "state"). It generally does not cover the laws and regulations of Guam, Puerto Rico, or the U.S. Virgin Islands.

400 See Section II.A.1, supra.

401 States may also require investment advisers to make notice filings of documents filed with the Commission, and to pay filing, registration, and licensing fees. See NSMIA Section 307(a).

402 State examinations are discussed in Appendix A, infra.

403 States may not require an investment adviser to register if it (i) does not have a place of business in the state and (ii) has fewer than six clients who are state residents during the past twelve months. See Advisers Act Section 222(d). Section 203A(b)(1) also prohibits a state from imposing registration or licensing requirements on an investment adviser that is excluded from the definition of investment adviser by Section 202(a)(11). Currently, Wyoming does not have a statutory requirement for investment adviser registration.

The state registration process[404] is substantially similar to the federal registration process, as states require investment advisers to complete Form ADV (Parts 1 and 2) and file it electronically through the IARD system.[405] Some states also require investment advisers to file additional documents, such as sample client agreements, articles of incorporation or other similar organizational documents, proof of errors and omission coverage, and information about the advisers' financial condition.[406]

States generally impose requirements upon state-registered investment advisers that are similar to those under the Advisers Act, although the requirements are not uniform among the states. There are some instances in which state regulation differs from federal regulation. For example, states generally require state-registered investment advisers to: be bonded if they have custody of or discretion over client funds or securities;[407] maintain minimum net capital;[408] and file financial information with the

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404 While an analysis of each state's registration requirements is beyond the scope of this Report, states exempt an investment adviser from registration if the adviser did not have a place of business in the state during the last twelve months and does not have more than five clients that are resident in that state, as required by Advisers Act Section 222(d). Most states also exempt an investment adviser from registering if its only clients are financial institutions, such as investment companies as defined in the Investment Company Act, other investment advisers, broker-dealers, banks, trust companies, savings and loan associations, insurance companies, employee benefit plans with assets of not less than $1 million, and government agencies or instrumentalities, and other institutional investors that the state may define by rule or order. See, e.g., Alabama (Ala. Code, Art. 1 §8-6-3), Alaska (Alaska Stat. §45.55.030 (c)), California (Cal. Corp. Code §25202(b)); Colorado (Col. Rev. Stat. §11-51-402); Connecticut (Conn. Gen. Stat. §36b-6(e)) (note, however, that the exemption does not apply to advisers who take part in wrap fee programs); Delaware (Del. Code Ann. Tit. 6; §7313(c)(2)); Indiana (Ind. Code §23-2-1-8(c)(2)). But see Texas (7 TAC §139.22) (exempting advisers to high net worth families from registration, where the advisers do not hold themselves out to the public as investment advisers).

405 See State Securities Regulators Report on Regulatory Effectiveness and Resources with Respect to Broker-Dealers and Investment Advisers (Sept. 24, 2010) ("NASAA Report") at 6 ("state regulators use the IARD to process Investment Advisers' registration/licenses"). As stated in Section II.C.1, the IARD was developed as part of a joint effort by the Commission, the states, and the NASD.

406 Id. at 7. See also NASAA Model Rule USA 2002 403(a) (2002). See, e.g., Arkansas (available at http://www.securities.arkansas.gov/page/354/broker-dealer-investment-advisor) and Nebraska (available at http://www.ndbf.ne.gov/forms/iareg.pdf). Maryland requires applicants to submit copies of all brochures and a sample copy of the adviser's advisory contract. See Md. Reg. Code tit. 02 §0.51(A)(3).

407 See NASAA Model Rule USA 2002 411(e)-1, Bonding Requirements for Investment Advisers. See, e.g., Maryland (Md. Corps. & Ass'ns Code Ann. 11-410(a)(3)); Massachusetts (Mass. Gen. L. ch 110A; § 202(d)). Mass Regs. Code tit. 950, §12.205(a)(1) and Mass. Regs. Code tit. 950, §12.205(5)(b)); Oregon (Or. Rev. Stat. §59.175(4)); Or. Admin. R. 441-175-110(4)). But see Nebraska (Neb. Rev. Stat. §8-1103(4)(b)(v) (no bonding requirements exist currently, although the state administrator may authorize such requirements).

408 See NASAA Model Rule USA 2002 411(a)-1, Minimum Financial Requirements for Investment Advisers (requiring investment advisers to maintain a minimum net worth ranging from $10,000 to $35,000, depending on whether the adviser has custody or discretionary authority over client

states.[409] Some states may require an investment adviser or its supervisory or control individual (if the investment adviser is a firm) to pass an exam, which may be waived if the investment adviser holds a certain designation or has passed the exam within two years of its investment adviser registration application.[410] Some states also have adopted rules specifically prohibiting investment advisers from engaging in certain conduct, such as recommending securities without a reasonable basis to believe that the recommendation is suitable for the client, excessive trading, borrowing money or securities from a client, or lending money to a client (subject to certain exceptions, such as when the client is a broker-dealer or a financial institution engaged in the business of loaning funds).[411]

Regulation of Investment Adviser Representatives

States generally impose registration, licensing, or qualification requirements on investment adviser representatives who have a place of business in the state, regardless of whether the investment adviser is registered with the Commission or with the states.[412]

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funds or securities). See, e.g., Maryland (MD. Corps. & Ass'ns Code Ann. §11-409(A)(2) and Md. Regs. Code tit. 02, §5.14); Massachusetts (Mass. Regs. Code. Tit. 950 §12.205(5)(a)(2); Nebraska (Nev. Rev. Stat. §8-1103(4)(b)(v); Neb. Admin. R. & Regs.7-008.01A and 7-008.01B). But see states where the statutes permit the state administrator to set a net capital requirement, but there are no current requirements, e.g. Maine (Me. Rev. Stat. Ann. tit. 32 § 10310(2)); Michigan (Mich. Comp. Laws §451.602(f)) and Minnesota (Minn. Stat. §80A.05(4)).

409 See NASAA Model Rule USA 2002 411(b)-1, Financial Reporting Requirements for Investment Advisers (requiring investment advisers with custody or discretionary authority to file audited or unaudited balance sheets, as the case may be, at the end of the investment adviser's most recent fiscal year).

410 See NASAA Model Rule USA 2002 412(e)-1, Examination Requirements (acceptable designations are: Certified Financial Planner awarded by the Certified Financial Planners Board of Standards; Chartered Financial Consultant or Masters of Science and Financial Services awarded by the American College, Bryn Mawr, Pennsylvania; Chartered Financial Analyst awarded by the Institute of Chartered Financial Analysts; Personal Financial Specialist awarded by the American Institute of Certified Public Accountants; or Chartered Investment Counsel awarded by the Investment Adviser Association). See, e.g., Alabama (Ala. Code §8-6-3(f)(1) and Ala. Admin. Code R. 830-X-3-.08(4)(a) and (b)); Florida (Fla. Stat. §517.12(8); Fla. Admin. Code Ann. R. 3E-600.005(3); Fla. Admin. Code Ann. R. 3E-600.005(4); Fla. Admin. Code Ann. R. 3E-600-005(5)); Georgia (Ga. Code Ann. §10-5-3(e); Ga. Comp. R. & Regs. R. 590-4-8-.07); Illinois (815 Ill. Comp. Stat. §5/8(d)(9)); Ill. Admin. Code tit. 14, §130.842(c)); Oklahoma (Okla. Sec. Comm'n Admin. R-660:10-7-13(b); Pennsylvania (Pa. Stat. Ann. Tit. 70, § 1-303(c); 64 Pa. Code §303.032(a)); and Rhode Island (R.I. Gen. Laws §7-11-207(b)).

411 See NASAA Model Rule USA 2002 502(b), Prohibited Conduct in Providing Investment Advice. See, e.g., Colorado (Colo. R. 51-4.8(IA); Hawaii (Haw. Admin. R §16-39-4070); Iowa (Iowa State Reg. 191-50.38(502)); Kansas (Kan. Admin. Regs. 81-14-5); and Mississippi (MS ADC Sec'y of State Rule 62).

412 Advisers Act Rule 203A-3 defines an "investment adviser representative" of an investment adviser as a supervised person of the investment adviser (i) who has more than five clients who are natural persons (other than qualified clients, as that term is defined in Advisers Act Rule 205-(3)(d)(1)), and (ii) more than ten percent of whose clients are natural persons (other than qualified clients, as

In general, states that register and regulate investment adviser representatives require that they register on Form U4 and pay a fee. Most states also require the investment adviser representative to pass the same exams or hold the same designations as they require for investment advisers.[413]

b) Other Federal and State Regulation Intended to Protect Advisory Clients

ERISA Regulation

Some investment advisers also may be regulated as fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA").[414] While the requirements of ERISA are beyond the scope of the Study, generally investment advisers

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that term is defined in Advisers Act Rule 205-(3)(d)(1)). Rule 203A-3 also provides that, for purposes of defining an investment adviser representative, a supervised person is not an investment adviser representative if the supervised person (i) does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser, or (ii) provides only impersonal investment advice, which means investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts. The rule defines a "place of business" of an investment adviser representative as (i) an office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, and (ii) any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

413 See NASAA Rule USA 2002 404(a), Application for Investment Adviser Representative Registration and NASAA Model Rule USA 2002 412(e)-1, Examination Requirements. See, e.g., Alabama (Ala. Code §8-6-3(f)(1) and Ala. Admin. Code R. 830-X-3-.08(4)(a) and (b)); Florida (Fla. Stat. §517.12(8); Fla. Admin. Code Ann. R. 3E-600.005(3); Fla. Admin. Code Ann. R. 3E-600.005(4) and Fla. Admin. Code Ann. R. 3E-600-005(5)); Georgia (Ga. Code Ann. §10-5-3(e) and Ga. Comp. R. & Regs. R. 590-4-8-.07); Illinois (815 Ill. Comp. Stat. §5/8(d)(9) and Ill. Admin. Code tit. 14, §130.842(c)); Oklahoma (Okla. Sec. Comm'n Admin. R-660:10-7-13(b)); Pennsylvania (Pa. Stat. Ann. Tit. 70, §1-303(c) and 64 Pa. Code §303.032(a)); Rhode Island (R.I. Gen. Laws §7-11-207(b)).

414 Some commenters have expressed concerns that any changes to the investment adviser or broker-dealer standards of care may have an impact on ERISA-regulated plans. See, e.g., UBS Letter, supra note 39 (stating that "because the law applicable to retirement accounts often restrict services and products that the fiduciary may provide, extending new standards outside the securities context could inadvertently prevent clients from accessing the services and products that they currently have in these accounts"); BOA Letter, supra note 17 ("We encourage the SEC to make clear that any new, harmonized standard of care does not necessarily implicate principal trading and other restrictions that may accompany certain types of fiduciaries (e.g., ERISA)"); and letter from Carl B. Wilkerson, Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers, dated Aug. 30, 2010 ("ACLI Letter") ("Accordingly, if any harmonized standard of care rules are promulgated, it is important that the SEC specifically establish that any such rules are not intended to confer fiduciary status on a [broker-dealer], [investment adviser] or their associated persons"). See Section IV infra, stating that the Study does not have any direct bearing on other persons who may be characterized as fiduciaries in other areas of the law, including ERISA fiduciaries or financial institutions such as banks and trust companies.

may be ERISA fiduciaries if they: exercise authority or control over the management or disposition of employee benefit plans that are covered by ERISA (a "plan"); provide investment advice for a fee with respect to plan assets, or have authority or responsibility to do so; or have discretionary responsibility or authority to administer a plan.[415] In general, an ERISA fiduciary must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.[416] ERISA requires, among other things, that a fiduciary must diversify a plan's investments so as minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.[417] ERISA also prohibits a number of transactions, particular those involving conflicts of interest between the plan and certain parties in interest.[418]

Bank and Trust Company Regulation

Advisers Act Section 202(a)(11)(A) excludes banks and bank holding companies that do not advise investment companies from the definition of investment adviser. For purposes of this exclusion, a "bank" is defined in Advisers Act Section 202(a)(2) to include nationally chartered banks, federal savings associations, and members of the Federal Reserve System and state chartered banks if their activities are similar to those engaged in by national banks and if they are regulated by state or federal banking authorities. Section 202(a)(2) also defines a "bank" as a trust company where the substantial portion of its business consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of the Advisers Act.[419] To the extent

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415 In addition to employee benefit plans, IRAs and Keoghs may be treated as benefit plans under the Internal Revenue Code and are therefore subject to similar requirements. See Internal Revenue Code Section 4975(e). The Department of Labor recently proposed a rule under ERISA that would broadly define the circumstances under which a person is considered to be a "fiduciary" for ERISA purposes by reason of giving investment advice to an employee benefit plan or a plan's participants. See "Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 CFR pt. 2510).

416 ERISA Section 404(a).

417 Id.

418 ERISA Section 406 (note that the Department of Labor has issued a number of exemptions to certain of the prohibited transactions enumerated under the section. For example, Prohibited Transaction Exemption 75-1, Part II, in general permits plans to engage in principal transactions involving securities with U.S. registered broker-dealers if certain conditions are satisfied. The "qualified professional asset manager" exemption permits securities transactions between plans and parties in interest.).

419 Non-U.S. banks, credit unions and SIDs (discussed below) are not entitled to rely on the Section 202(a)(11)(A) exclusion. For purposes of this exclusion, a "bank" is defined in Advisers Act Section 202(a)(2) to include nationally chartered banks, federal savings associations, and members

that banks and trust companies offer investment advisory services that may overlap with those of Commission- and state-registered investment advisers, there may be differences in the applicable regulation and standards of care.[420]

2. Broker-Dealers

a) Overview of State Regulation Intended to Protect Retail Customers

The federal securities laws grant the Commission non-exclusive jurisdiction over securities broker-dealers. Accordingly, and as noted in Section II.B.2 above, a broker-dealer generally must register with the Commission and an SRO,[421] and comply with all applicable state requirements, including registration requirements. While state laws vary, all states require broker-dealers and their agents[422] to register with or be licensed by the

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of the Federal Reserve System and state chartered banks if their activities are similar to those engaged in by national banks and if they are regulated by state or federal banking authorities. A "bank holding company" eligible for this exclusion is generally defined in the Bank Holding Company Act of 1956 as a company that "controls" a bank or bank holding company (through direct or indirect ownership or power to vote 25 percent or more of a class of voting securities or through power to control the election of directors). Banks or bank holding companies that advise registered investment companies must register as an investment adviser. However, where the bank advises the investment company through a "separately identifiable department or division" (a "SID"), which is a unit supervised by officers designated by the bank's board to run the investment company advisory activities and which maintains separate records from the bank, only the SID is deemed to be an investment adviser and is required to register. The staff has taken the position that the exclusion is generally not available to non-bank affiliates or subsidiaries of excluded banks or excluded bank holding companies (see, e.g., First Commerce Investors, Inc., SEC Staff No-Action Letter (Jan. 31, 1991); New England Merchants National Bank, SEC Staff No-Action Letter (Dec. 12, 1989); New England Merchant National Bank, SEC Staff No-Action Letter (June 1, 1974)); or foreign banks (see Kingland Capital, SEC Staff No-Action Letter (Mar. 29, 1991)).

420 12 CFR Part 9 sets forth the standards that apply to the fiduciary activities of national banks. This part applies to all national banks and federal branches of foreign banks that act in a fiduciary capacity. While Part 9 reflects common fiduciary principles and its provisions are not specific to a particular state law or a type of fiduciary instrument, certain parts are linked to other fiduciary laws. See also "*Personal Fiduciary Services, Comptroller's Handbook*" at http://www.occ.gov/static/publications/handbook/Pfsfinal.pdf**.**

421 A broker-dealer that conducts all of its business in one state does not have to register with the Commission. See Exchange Act Section 15(a)(1). The Commission staff interprets this intrastate exception from registration narrowly. See Guide to Broker-Dealer Registration, supra note 25. To qualify, all aspects of all transactions must be done within the borders of one state. Id. This means that, without Commission registration, a broker-dealer cannot participate in any transaction executed on a national securities exchange or Nasdaq. Id. Also, information posted on the Internet that is accessible by persons in another state would be considered an interstate offer of securities or investment services that would require Federal broker-dealer registration. Id. An intrastate broker-dealer remains subject to the registration requirements of the state in which it conducts business. Id.

422 The Uniform Securities Act defines an "agent" as "any person other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases of sales of

securities regulators of the states in which they conduct their business.[423] As noted above, most states allow broker-dealer registration by the filing of Form BD with CRD,[424] and agent registration is typically accomplished by the filing of the Form U4 with CRD.[425] Although filing of a Form BD or U4 with CRD may satisfy a state's filing requirement, it does not necessarily result in automatic registration in all states.[426] Some states may also require applicants to file additional documents, including financial statements and statement of prior sales activities.[427] In addition, many states review a filing before registration may become effective.[428]

The Exchange Act includes two limited exemptions from the state registration requirements for associated persons. Specifically, Exchange Act Section 15(h)(1) provides that no state law may prohibit an associated person from effecting a transaction on behalf of an existing customer when the customer is temporarily in another state or while the associated person's state application for state registration is pending, provided that such associated person is not ineligible to register in that state, is registered with FINRA and at least one state, and is associated with a broker-dealer registered in that state.

Most jurisdictions also require agents to take a uniform examination, usually the Uniform Securities Agent State Law Examination (Series 63) or the Uniform Combined State Law Examination (Series 66), and/or a products examination for the type of activity

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securities. . . . A partner, officer or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise comes within the definition." Unif. Sec. Act § 401(b) (1956). Some state statutes use the terms "salesman," Sales person," or "sales representative" rather than the word "agent." Joseph C. Long, Blue Sky Law, §8:19 (2010). Most states have generally excluded clerical and ministerial personnel from the definition of agent. See id. at § 8:28.

423 See NASAA Report, supra note 405.

424 See CCH Blue Sky Law Reporter ¶ 6531; Joseph C. Long, Blue Sky Law, §8:2 (2010).

425 CCH Blue Sky Law Reporter ¶ 34; ¶ 6531.

426 See Joseph C. Long, Blue Sky Law, §8:2 (2010).

427 See NASAA Report, supra note 405 at 6.

428 See Joseph C. Long, Blue Sky Law, §8:2 (2010); letter from Denise Voigt Crawford, President, and David Massey, President Elect, North American Securities Administrators Administration, Inc., dated Aug. 30, 2010 ("NASAA Letter") ("The examination process at the state level typically begins before an entity ever becomes a registrant. State securities regulators . . . review information submitted by applicants to determine whether the applicant satisfies the state's registration requirements. This examination includes an evaluation of the applicant's history as disclosed on the Form[s] BD. . . .); and NASAA Report, supra note 405 at 7 ("Before a Broker-Dealer [or] its agents . . . can do business in a state, their registration/licensing is subjected to a thorough examination. State securities regulators review all registration forms for Broker-Dealer [and] agent . . . applicants".).

in which the applicant will engage.[429] State law may also subject agents to continuing education requirements.

Most states impose bonding, net capital, custody, financial statement reporting, and recordkeeping requirements on broker-dealers.[430] However, the Exchange Act prohibits states from establishing capital, custody, margin, financial responsibility, recordkeeping, bonding or financial operational reporting requirements for broker-dealers registered under the Exchange Act that differ from or are in addition to those established under the Exchange Act.[431] Accordingly, the states' requirements conform to federal law.[432]

Similar to federal requirements, many states require broker-dealers and their agents to observe high standards of commercial honor and just and equitable principles of trade in the conduct of business, and/or prohibit a variety of enumerated unethical or fraudulent practices including, among others: making unsuitable recommendations; churning a customer's account; selling (or purchasing) a security to (or from) a customer with an excessively high mark-up (or mark-down); unauthorized trading; effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative or deceptive device, practice, plan, program, design or contrivance.[433] State laws also generally impose on a broker-dealer a duty to supervise its employees.[434]

State securities regulators also conduct examinations of broker-dealers for compliance with applicable state laws and regulations, particularly their branch and remote offices.[435] States monitor for compliance through a variety of means including, among other things, annual questionnaires and on-site and off-site examinations.[436] Given the complementary exam programs at the Commission and FINRA, state examinations of

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429 CCH Blue Sky Law Reporter ¶ 6531.

430 CCH Blue Sky Law Reporter ¶ 6531.

431 See Exchange Act Section 15(h)(1).

432 NASAA Letter, supra note 428.

433 See, e.g., Arkansas (003.14.2 Ark. Code R. §308.01); California (Cal. Corp. Code §§25216, 25218; Cal. Code Regs. tit. 10, §§260.218, 260.218.1-.2; Delaware (Del Admin. Code §609); District of Columbia (D.C. Mun. Regs. tit. 17, §1819); Florida (Fla. Admin. Code. Ann. r. 69W-600.013); Georgia (Ga. Comp. R. & Regs. 590-4-2-.14); New Jersey (N.J. Stat. Ann. §49:3-58(a)(2)(vii); N.J. Admin. Code §13:47A-6.3); Pennsylvania (64 Pa. Code §305.019). See also NASAA, Dishonest or Unethical Business Practices of Broker-Dealers and Agents (May 23, 1983).

434 Joseph C. Long, Blue Sky Law, §8:8 (2010).

435 See NASAA Letter, supra note 428.

436 See NASAA Letter, supra note 428.

broker-dealers are often "for-cause" or address special circumstances.[437] A more detailed discussion of state examinations is included in Appendix A.

b) Other Regulation Intended to Protect Retail Customers

ERISA

As noted above, while the requirements of ERISA are beyond the scope of this Study, broker-dealers generally are not considered ERISA "fiduciaries," as traditional recommendations by broker-dealers would not usually constitute "investment advice" for ERISA purposes.[438] Moreover, the Department of Labor's ERISA regulations contain a "safe harbor" from the definition of "fiduciary" for the execution of securities trades by a broker-dealer pursuant to the specific instructions of an independent fiduciary of an ERISA plan.[439] However, a broker-dealer may be deemed to be an ERISA fiduciary when it exercises discretion beyond that permitted under the regulations.[440] To the extent a broker-dealer is deemed to be an ERISA fiduciary, the various ERISA requirements would apply.[441]

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437 See NASAA Report, supra note 405 at 3.

438 ERISA Section 3(21)(A) generally provides that a person is a "fiduciary" with respect to a plan to if they (1) exercise any discretionary authority in the management or administration of the plan, or any authority or control respecting management or disposition of plan assets or (2) render investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so. The Department of Labor's current regulations generally provide that a person shall be deemed to be rendering "investment advice" within the meaning of ERISA Section 3(21)(A) only when such person renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property, and either (1) has discretionary authority or control with respect to investing plan assets or (2) provides such advice on a regular basis pursuant to a mutual agreement, arrangement or understanding that such advice will serve as the primary basis for investment decisions with respect to plan assets and is individualized to meet the particular needs of the plan . See 29 CFR 2510.3-21(c).

As stated above in note 415, supra, the Department of Labor recently proposed a rule under ERISA that would broadly define the circumstances under which a person (including a broker-dealer and an investment adviser) is considered to be a "fiduciary" for ERISA purposes by reason of giving investment advice to an employee benefit plan or a plan's participants. See "Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 CFR pt. 2510).

439 29 CFR 2510.3-21(d)(1). In particular, to qualify for the safe harbor from the definition of a "fiduciary," the instructions must specify: (1) the security to be purchased or sold; (2) the price range within which such security is to be purchased or sold; (3) a time span during which such security may be purchased or sold (not to exceed five business days); and (4) the minimum or maximum quantity (or dollar value) of such security that may be purchased or sold within such price range. Id.

440 See 29 CFR 2510.3-21.

441 See supra note 388.

Bank and Trust Company Regulation

Historically, banks were completely excluded from the definitions of broker and dealer in Exchange Act Sections 3(a)(4) and (5).[442] The Gramm-Leach-Bliley Act of 1999 ("GLB Act") amended those sections to replace the bank exclusions with narrower product- and transaction-specific exceptions for certain bank securities activities. The Commission and the Board of Governors of the Federal Reserve System (the "Board") jointly adopted rules known as "Regulation R" implementing the bank broker exceptions in Exchange Act Section 3(a)(4)(B).[443] The rules define the scope of securities activities that banks may conduct without registering with the Commission as securities brokers and implement the most significant GLB Act "broker" exceptions for banks. Specifically, the rules implement the statutory exceptions that allow a bank, subject to certain conditions, to continue to conduct securities transactions for its customers as part of the bank's trust and fiduciary, custodial and deposit "sweep" functions, and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer.[444]

The regulation of those bank securities activities excepted from the definition of "broker" and "dealer" by the GLB Act is determined by the appropriate banking regulator, and is beyond the scope of this Study.[445] To the extent that banks engage in broker or dealer activities but are not required to be registered with the Commission, there may be differences in the applicable regulation and standards of care that are outside the scope of the Commission's rulemaking and interpretive authority.

III. Retail Investor Perceptions and Confusion Regarding Financial Service Provider Obligations and Standard of Conduct

Americans seek investment advice, products, and services to help achieve a variety of goals, such as retirement planning, estate and insurance planning, educational needs, and the operation of small businesses. Baby boomers control roughly $13 trillion

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442 "Bank" is defined in Exchange Act Section 3(a)(6). The term "bank," however, is limited by section 3(a)(6) of the Exchange Act to banks directly regulated by U.S. state or federal bank regulators. The Commission has stated that the determination whether any particular financial institution meets the requirements of Section 3(a)(6) is the responsibility of the financial institution and its counsel. See Exchange Act Release No. 27017 at note 16 (July 11, 1989).

443 The broker exceptions for a bank in, including the trust and fiduciary exception, apply to each bank individually and are not available to a nonbank entity, including a nonbank subsidiary or affiliate of a bank. See Exchange Act Release No. 56501 (Sept. 24, 2007).

444 See Exchange Act Section 3(a)(4)(B) and Section 3(a)(5)(C). Banks have fewer exceptions from the definition of "dealer" than "broker;" the GLB Act provided 11 broker and 4 dealer exceptions.

445 For example, bank employees have engaged in making referrals of retail customers under existing Banking Agency guidance as well as the Commission rules and interpretations. See Banking Agencies' Interagency Statement on Retail Sales of Nondeposit Investment Products (Feb. 15, 1994).

in household investable assets, or over 50 percent of total U.S. household investment assets, and nearly one in every six Americans will be 65 or older by the year 2020.[446] However, although retail investors look to investment advisers and broker-dealers to help achieve their financial goals, there is robust recent evidence that many retail investors do not understand or are confused by the different standards of care applicable to investment advisers and broker-dealers and their respective associated persons, although they were generally satisfied with their financial professional. This evidence includes investor and investor advocate comments submitted as part of the Commission's request for public comment on the Study, Commission-sponsored studies, and the results of surveys submitted to the Commission as part of the comments to the Study.

A. Investor and Investor Advocate Comments

Through the public comment process, many investors stated that they did not understand the standards of care applicable to investment advisers and broker-dealers, found the standards of care confusing, and in particular, were uncertain about the meaning of the multiple titles used by investment advisers and broker-dealers.[447] For example, many noted that they did not understand the difference between an investment adviser and a broker-dealer, much less any potential difference in the standards of care.[448]

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446 Protecting Senior Investors: Compliance, Supervisory and Other Practices used by Financial Services Firms in Serving Senior Investors, Securities and Exchange Commission Office of Compliance Inspections and Examinations, North American Securities Administrators Association, and Financial Industry Regulatory Authority (Sept. 22, 2008).

447 See, e.g., letter from Bert Oshiro, dated Aug. 29, 2010 ("Years ago, I was pretty sure who I was dealing with based on their titles… Today it's a totally different story. All kinds of products such as securities, insurance, fee based products, bank accounts, loans, health insurance, auto/homeowners insurance, etc. are sold by people calling themselves: financial advisors; financial consultants; investment advisors; investment consultants; financial planners; asset managers; financial services advisors; [and] registered representatives… It has come to the point that I really don't know who I'm dealing with."); letter from Larry J. Massung, dated Aug. 29, 2010 ("I believe there is considerable confusion within the general public with the fiduciary duty, responsibilities, and titles of brokers, dealers and investment advisors"); and letter from Cecylia Escarcega, dated Aug. 30, 2010 ("Personally, I find the titles confusing because the broker, dealer or investment advisor typically does not tell me what their role is and the scope of their fiduciary duty to me as an investor").

448 See, e.g., letter from Elizabeth Marion, dated Aug. 31, 2010 ("Until I read in Sunday's San Diego Union Tribune, I had NO IDEA the amazing differences between investment advisors, brokers dealers"); letter from Melissa Murphy, dated Aug. 29, 2010 ("My opinion on the average investor's view of brokers, dealers and investment advisors is that most have no idea as to the differences between the terms. However, changing the names will not fix that, and will be confusing to those who do understand the current terminology."); letter from L. Topper, dated Aug. 30, 2010 ("I would like to be included in your study as one who does not know the difference between brokers, dealers and investment advisers and these titles are confusing"); letter from Velma E. Bunne, dated Aug. 29, 2010 ("I don't think the average person who is not connected with a financial house or institution knows exactly to what extent brokers, dealers and investment advisors are currently regulated."); letter from Carolyn Peterson, dated Aug. 29, 2010 ("I didn't know the difference for the broker, adviser, and dealer, even though we have investments in the stock market"); letter from Nina Rusko, dated Aug. 29, 2010 ("The titles of brokers, dealers, investment advisers don't really explain how they differ one from another. I have

Many commenters also stated that financial professionals should act in the best interests of the investor.[449] This lack of investor understanding and general investor confusion regarding the roles of broker-dealers and investment advisers and the different standards of care applicable is reiterated in the comments submitted by investor advocate groups.[450]

B. Commission-sponsored Studies

The retail investor confusion noted in the above comments is also reflected in two Commission-sponsored studies regarding investor understanding of the roles, duties and obligations of investment advisers and broker-dealers.

1. Siegel & Gale, LLC and Gelb Consulting Group, Inc. Study

In 2004, the Commission retained Siegel & Gale, LLC and Gelb Consulting Group, Inc. ("SGG") to conduct focus group testing to determine, among other things, how investors differentiate the roles, legal obligations, and compensation between investment advisers and broker-dealers.[451] SGG conducted four focus groups tests.[452]

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no idea what kind of rules/standards there are for each of them and how that differs. It would be much easier for consumers who are choosing someone to help them if brokers, dealers and advisers of any kind had to follow the same rules and standards."); and letter from Linda Ewen, dated Aug. 29, 2010 ("I don't know the difference between a broker and an investment advisor. How do I know if the person I trust with my financial future is one or the other?").

449 See, e.g., letter from James D. Ferguson, dated Aug. 29, 2010 ("I do not find the distinction between brokers and investment advisors to be clear at all. As an individual investor I expect that either one of them have my best interests at heart"); letter from Thomas E. Lin, dated Aug. 24, 2010 ("I believe anyone that gives professional advice to clients regarding investments needs to be acting in the best interest of the client. This is not only fair but right"); letter from Elizabeth E. Dean, dated Aug. 30, 2010 ("In my opinion, broker-dealers and financial advisors should all be held to the same standard-namely, working in the best interest of their clients. I was not even aware that broker-dealers might be working in their own best interest rather than mine"); letter from Al Hughes, Jr., dated Aug. 30, 2010 ("I feel broker-dealers and their agents should be held to the same standards as investment advisors. The broker and agent should put the interests of the client first on every transaction"); letter from Joseph F. Melock, Jr., dated Aug. 29, 2010 ("I believe that "stock brokers/financial adviser" should be held to a fiduciary standard. They recommend stocks, bonds and mutual in which they have an interest of some degree, and not always in the best interest of the client. If their duty were to change they would truly be what they call themselves."); letter from Diane Burke, dated Aug. 28, 2010 ("I would appreciate to have all financial advisors operate to a 'best interest of the client' fiduciary standard. Any recommendation made by all financial advisors to the client should be based on the client's needs."); letter from David Certner, Legislative Counsel and Legislative Policy Director, American Association of Retired Persons, dated Aug. 30, 2010 ("AARP Letter") ("Investors deserve a regulatory policy that both enables them to make an informed choice among different types of investment professionals and ensures that all who are engaged in providing personalized investment advice act in their clients best interest.").

450 See, e.g. AARP Letter, supra note 449; letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, dated Aug. 30, 2010 ("CFA Letter").

451 See Siegel & Gale, LLC/Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures (Mar. 5, 2005) ("SGG Report"). The SGG Report is available at http://www.sec.gov/rules/proposed/s72599/focusgrp031005.pdf

Focus-group participants were asked to list the types of services provided by financial services professionals and to indicate which type of professional provided that service, recognizing that different professionals might perform similar or overlapping services. The participants were asked to perform a similar task using a list of specific services and obligations. In general, both groups did not understand that the roles and legal obligations of investment advisers and broker-dealers were different. In particular, they were confused by the different titles (e.g., financial planner, financial advisor, financial consultant, broker-dealer, and investment adviser), and did not understand terms such as "fiduciary."[453]

The SGG focus group testing sampled the views of a few dozen investors. Thus, while relevant to our knowledge of investor confusion about investment adviser and broker-dealer standards of care, the small sizes of the samples cannot be reliably projected to the general population.

2. RAND Report

In 2006, the Commission retained RAND to conduct a study of broker-dealers and investment advisers for the purpose of examining, among other things, whether investors understood the duties and obligations owed by investment advisers and broker-dealers to their clients and customers, respectively.[454] RAND carried out the study by, among other things, analyzing the business practices of thousands of investment advisers and broker-dealers based on their regulatory filings and conducting interviews with stakeholders (including members of the investment adviser and broker-dealer industries).[455] It also conducted a large-scale survey on household investment behavior

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452 Two focus groups met in Memphis and two groups met in Baltimore for ninety-minute sessions. Each focus group had eight or nine participants. Focus-group participants had varying degrees of financial sophistication, but each participant: made investment decisions either solely or jointly; graduated high school, attended some college or graduated college (those with graduate degrees were excluded from the study); received investment advice from a financial services professional regarding stocks, bonds, mutual funds, or 529 plans in the past six months; managed investments primarily through a financial services professional; did not have more than 50% of their assets in no-load mutual funds; and passed an articulateness screener.

453 For example, one participant stated: "I don't know the difference. I mean I've got a guy that gives me advice. I don't know what he is." (Baltimore). SGG Report, supra note 451 at 2.

454 See Angela A. Hung, et al., RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers at xvi (2008) ("RAND Report").

455 RAND relied on Form ADV data from the IARD, Form BD data from the CRD, and Focus report filings, Parts II and IIA (since amended and are now Parts 2 and 2A), made by broker-dealers, available during 2001-2006. RAND conducted 26 interviews with representatives from interested parties. The interviews included seven financial service industry groups representing investment advisers, broker-dealers, and financial planners; five consumer protection, education, or research groups; nine interviews with federal and state regulators; and five academic participants. The remaining interviews were with individuals. RAND also conducted an additional 34 interviews with financial professionals from investment advisory and brokerage firms.

and preferences, experience with financial service providers, and understanding of the different types of financial service providers.

a) Firm Analysis

RAND concluded that it was difficult for it to identify the business practices of investment advisers and broker-dealers with any certainty. Some of the difficulties stemmed from the complex affiliations and relationships of firms that offered multiple services. In addition, some investment adviser-only firms had employees who were registered representatives of a broker-dealer. Despite these challenges, RAND found that the financial services industry was "extremely heterogeneous" in terms of firm size, services offered, activities of affiliated firms and other factors.[456] RAND reported that the more numerous smaller firms tended to provide a more limited and focused range of either investment advisory or brokerage services, and the larger firms tended to engage in a much broader range of products and services, offering both investment advisory and brokerage services. RAND noted that the differences in the services provided by financial firms and their affiliations could be difficult for investors to understand, as information was not presented uniformly, with some firms providing so much information that it would be difficult for an investor to process, and others providing scant information. RAND's interviews with investment adviser and broker-dealer firms found that the firms believed that investors tended to trust a particular firm, without necessarily understanding of the firm's services and responsibilities.

b) Investor Survey

Both RAND's and the firms' beliefs about investor understanding were confirmed in RAND's investor survey. A total of 654 households completed the survey.[457] The household investor survey included questions on investment experience, beliefs about differences between investment advisers and broker-dealers, and experience with financial service providers. RAND characterized about two-thirds of the household survey respondents as experienced investors and one-third as inexperienced.[458] RAND also conducted six focus groups with investors in Alexandra, Virginia, and Fort Wayne,

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456 RAND Report, supra note 454 at 117.

457 RAND Report, supra note 454 at 88. The households were selected from the American Life Panel ("ALP"). The ALP was an internet panel of more than 1,000 respondents aged 18 and older who responded to monthly surveys from the University of Michigan's Survey Research Center. RAND noted that ALP households tended to have more education and income than the U.S. population as a whole. As a result, RAND cautioned that its survey results likely overstated the levels of financial knowledge, literacy, and experience of the U.S. population. Id.

458 RAND deemed investors to be "experienced" if they held investments outside of retirement accounts, had formal training in finance or investing, or held investments only in retirement accounts but answered positively to questions gauging their financial understandings, such as the nature and causes of increases in their investments. RAND deemed investors to be "inexperienced" if they did not meet the "experienced" criteria.

Indiana. Each location included two groups of experienced investors and one group of inexperienced investors.

RAND presented the household survey participants with a number of specific services and duties (such as executing stock trades, the duty to disclose conflicts of interest, and to act in the investors' best interest) and asked the participants to identify whether investment advisers, financial advisors, financial consultants, or broker-dealers offered the service or were required to adhere to the specific duty.

To gauge the focus-group participants' initial understanding of the differences between investment advisers and broker-dealers, RAND administered a short questionnaire before the detailed discussion. The questionnaire was similar to the survey questions, and elicited a similar response: participants were more likely to say that brokers (rather than investment advisers) executed securities transactions and earned commissions, and they viewed financial advisors and financial consultants as being more similar to investment advisers than to brokers in terms of services and duties.

RAND's survey respondents and focus-group participants reported that they did not understand the differences between investment advisers and broker-dealers, although they were generally satisfied with the services they received from their financial professional. Participants noted that the common job titles for investment advisers and broker-dealers were too similar and therefore confusing (e.g., advisor, financial advisor, or financial consultant). Focus-group participants shed further light on this confusion when they commented that the interchangeable titles and "we do it all" advertisements made it difficult to discern broker-dealers from investment advisers.[459] Some participants said that they knew which type of investment professional they had, but most did not. The participants' confusion persisted even when RAND provided participants with fact sheets on investment advisers and brokers that included a description of their common job titles, legal duties, and typical compensation.

Similarly, RAND also found that not only did the focus-group participants not understand the differences between investment advisers and broker-dealers, they could not identify correctly the legal duties owed to investors with respect to the services and functions investment advisers and brokers performed. The primary view of investors was that the financial professional – regardless of whether the person was an investment adviser or a broker-dealer – was acting in the investor's best interest. RAND also found that some focus-group participants did not understand the term "fiduciary" and did not

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[459] RAND found some key differences between these responses from focus-group participants and responses from household survey respondents. Focus-group participants were more likely to report that both investment advisers and brokers are required to act in the investor's best interest (64 percent and 63 percent, respectively) than did ALP respondents (49 percent and 42 percent, respectively). Furthermore, focus-group participants were more likely than survey respondents to report that brokers are required to disclose any conflicts of interest. In fact, focus-group participants were more likely to report that brokers, rather than investment advisers, must disclose conflicts, whereas household survey respondents were more likely to report that investment advisers must disclose conflicts. RAND Report, supra note 454 at 109.

know whether a fiduciary standard was a higher standard than a suitability standard. In addition, other participants did not think that the legal requirements for either investment advisers or brokers were stringent enough. Several participants mentioned that, if an investment adviser made a costly mistake with a client's money, they thought that it would be extremely difficult to prove that the adviser was not acting in what he or she perceived to be the client's best interest. Other participants thought that "suitable" was too vague a term and that it was not clear how the broker would determine suitability. Moreover, the focus-group participants expressed doubt that the standards of care for investment advisers and broker-dealers were different in practice. Many participants also noted that investment advisers had to disclose conflicts of interest while brokers did not, and also were interested in the fact that broker-dealers must pass an examination and hold a license, while investment advisers did not.

RAND also found differences between the experienced and inexperienced focus-group participants. In particular, the inexperienced focus-group participants noted that they did not understand the terminology used by the financial services industry. They also felt uncomfortable asking questions about or generally talking about money, and tended to avoid the topic. The inexperienced focus-group participants believed that financial information should be presented more in terms of practical concepts. Some participants struggled with basic financial distinctions, such as the differences between stocks and mutual funds.

c) RAND's Conclusion

Based on its analysis and survey results, RAND concluded that the financial services market had become more complex over the last few decades in response to market demands for new products and services and the regulatory environment. In addition, financial services firms began to use a variety of titles to describe their personnel, such as "financial advisor," "financial consultant" and "advisor." As a result, the distinctions between investment advisers and broker-dealers have become blurred, and participants had difficulty determining whether a financial professional was an investment adviser or a broker-dealer and instead believed that investment advisers and broker-dealers offered the same services and were subject to the same duties, although generally investors were satisfied with their financial professional.

C. CFA Survey

More recently, some industry advocates and certain industry groups submitted the results of a survey that they conducted ("CFA Survey"), which again suggests that investors do not understand the differences between investment advisers, broker-dealers and financial planners and are not knowledgeable about the different standards of conduct

that apply to the advice or recommendations made by such financial services providers.[460]

The CFA Survey was conducted by telephone August 19-23, 2010, and sampled 2,012 adults. The CFA Survey asked a number of questions designed to elicit participants' views on the differences between investment advisers and broker-dealers, and the standard of conduct applicable to them. For example, the CFA Survey asked participants whether the primary service of broker-dealers was:

- "to buy and sell and they give only limited advice;" (29% selected this option);
- "to offer advice;" (34% selected this option); or
- "advice and transaction assistance are equally important services" (27% selected this option).

With respect to the standard of conduct of investment advisers and broker-dealers, the CFA Survey asked "if a stockbroker and an investment adviser provide the same kind of investment advisory services, do you think they should have to follow the same investor protection rules?" to which 91% of survey participants responded affirmatively. The CFA Survey also asked that whether participants agreed with the statement that "when you receive investment advice from a financial professional, the person providing the advice should put your interests ahead of theirs and should have to tell you upfront about any fees or commissions they earn and any conflicts of interest that potentially could influence that advice" (85% of participants strongly agreed, 12% somewhat agreed, 1% somewhat disagreed or strongly disagreed).[461] The CFA Survey also found that a majority of investors surveyed incorrectly believed that stockbrokers and "financial advisors" are held to a fiduciary duty (66% and 76% of investors surveyed, respectively),

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460 See letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, et al., dated Sept. 15, 2010 (submitting the results of a national opinion survey regarding U.S. investors and the fiduciary standard conducted by ORC/Infogroup for the Consumer Federation of America, AARP, the North American Securities Administrators Association, the Certified Financial Planner Board of Standards, Inc., the Investment Adviser Association, the Financial Planning Association and the National Association of Personal Financial Advisors ("CFA Survey")). In addition to the CFA Survey, Dr. Robert N. Mayer and Dr. Cathleen D. Zick of the University of Utah submitted the results of their survey conducted in October 2009. They asked 3,010 employees of the University of Utah the following question: "Do any of the following designations [certified financial planner, licensed/registered investment advisor, licensed/registered broker-dealer agent, and personal financial advisor] indicate that the advisor pledges to put your financial interests before his or hers?" The choices were "Yes," "No," or "Don't Know." They acknowledged that there was some debate as to whether each of the four types of financial services professionals was obligated to put their financial interests before the client or customer, but they pointed out that only about two-fifths of respondents were confident enough to offer a definitive (and sometimes incorrect) answer. See letter from Dr. Robert N. Mayer and Dr. Cathleen D. Zick, University of Utah, dated Aug. 26, 2010.

461 CFA Survey, supra note 460 at 19.

while most investors surveyed understand that the fiduciary standard is in place for "financial planners" and "investment advisers" (75% and 77% of investors surveyed, respectively).

D. Conclusion

The foregoing comments, studies, and surveys indicate that, despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities. This lack of understanding is compounded by the fact that retail customers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals. Retail investors are relying on their financial professional to assist them with some of the most important decisions of their lives. Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations.

Therefore, in light of this confusion and lack of understanding, it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It also is important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard. Under a uniform fiduciary standard, retail investors can be made more confident in the integrity of the advice they receive as they invest for their own and their families' critical financial goals. At the same time, it is necessary to ensure that any uniform standard allows and ensures retail investors to continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide.

IV. Analysis and Recommendations

This section analyzes the overlaps, shortcomings and gaps between the two regulatory regimes governing personalized investment advice about securities to retail investors by broker-dealers and investment advisers and identifies areas where the Staff recommends changes by rule or statute. This section makes two core sets of recommendations.

First, the Staff recommends that the Commission engage in rulemaking specifying a uniform fiduciary standard of conduct that is no less stringent than currently applied to investment advisers under Advisers Act Sections 206(1) and (2) that would apply to broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers. Accompanying that core recommendation are more

detailed recommendations addressing the implementation of the uniform fiduciary standard.

Second, the Staff recommends that regulatory protections related to personalized investment advice about securities to retail customers should be harmonized to the extent that harmonization appears likely to add meaningful investor protection. The discussion accompanying this recommendation identifies selected relevant areas where broker-dealer and investment adviser regulation differ, and where the Staff recommends the consideration of rules, interpretive guidance, or statutory changes that would produce such harmonization.

Finally, this section discusses alternatives to the uniform fiduciary standard that the Staff considered but does not recommend, including repeal of the broker-dealer exclusion in the Advisers Act. The Staff believes that these alternatives would entail significant costs that would not be justified by any potential benefits of these alternatives, as discussed separately in the Cost Analysis in Section V.

A. General Differences in Investment Adviser and Broker-Dealer Regulation

Investment advisers and broker-dealers are subject to extensive regulation and oversight designed to protect clients and customers, whether retail or other. Both regulatory regimes require investment advisers and broker-dealers to adhere to high standards of conduct in their interactions with retail investors, which are intended to encourage both broker-dealers and investment advisers to act in the interests of their investors and minimize conflicts of interests when providing personalized investment advice or recommendations. The two regulatory schemes currently seek to protect investors through different approaches.[462]

The broker-dealer regulatory regime has been characterized as predominantly a rules-based approach.[463] It governs, among other things, the way in which broker-dealers

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462 See letter from David G. Tittsworth, Executive Director, Investment Adviser Association, dated Aug. 30, 2010 ("IAA Letter") ("The current regulatory landscape reflects the different purposes of the two main statutes regulating investment advisers and broker-dealers…").

463 Exchange Act Section 19 generally provides the Commission fifteen calendar days from the date an SRO posts its rule change proposal on a public website to publish the proposal in the Federal Register. If the Commission fails to affirmatively act within the allotted time, the proposed rule will be deemed published as of the date on which the SRO posted its proposal on the website. In practice, however, Commission staff considers each proposed SRO rule filing before either approving or disapproving the rule by delegated authority or recommending the Commission either approve or disapprove the rule, or institute proceedings to determine whether to disapprove. See Exchange Act Section 19(b); see also Appendix A. FINRA has described that in consolidating rules of the NYSE and of the NASD, it has considered taking "a principles-based and tiered approach to the app lication of rules according to firm size and business model, as well as recognizing possible distinctions in application between retail and institutional customers." FINRA, Information Notice (Rulebook Consolidation Process) (Mar. 12, 2008). See also Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving

operate, focusing in large measure on applying rules embodying principles of fairness and transparency to relationships between broker-dealers and customers.[464] Accordingly, the Exchange Act, the rules thereunder, SRO rules, as well as judicial and Commission interpretations of the foregoing, govern a wide variety of brokerage activity related to effecting securities transactions, including advising customers, executing orders on the most favorable terms, arranging for delivery and payment, maintaining custody of customer funds and securities, and delivering required disclosures such as confirmations and account statements.[465] Exchange Act rules are generally designed to prevent fraud, and underpin broker-dealers' obligations to their customers, while sales practices obligations are largely imposed by SRO rules and are designed to address unethical behavior that may not necessarily be fraudulent. The federal securities laws and SRO rules address broker-dealer conflicts in one of three ways: express prohibition;[466] mitigation;[467] or disclosure.[468]

Proposed Rule Change To Amend the By-Laws of NASD To Implement Governance and Related Changes To Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 56145 (July 26, 2007) ("In the Commission's view, the consolidation of NASD and NYSE member firm regulation is intended to help reduce unnecessary regulatory costs while, at the same time, increase regulatory effectiveness and further investor protection. The Commission notes that the Transaction holds the potential to reduce unnecessary regulatory costs because New SRO firms would deal with only one group of examiners and one enforcement staff for member firm regulation.").

464 See, e.g., Guide to Broker-Dealer Registration, supra note 25.

465 See Exchange Act Release No. 27018 (July 18, 1989). See also IAA Letter, supra note 462.

466 For example, and as described in Section II.B.2, FINRA rules establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible. See FINRA Rules 2310, 2320, and 5110, and NASD Rule 2830.

467 For example, a broker-dealer may recommend a security even when a conflict of interest is present, but that recommendation must be suitable. As discussed infra Section II.B.2, under the antifraud provisions of the federal securities laws, a broker dealer is required to make only suitable recommendations, and when recommending a security, has a duty to disclose any material adverse facts or material conflicts of interests. See Hanly, 415 F.2d 589, supra note 271; Chasins, supra note 250; Hasho, supra note 250 .

468 For example, when engaging in transactions directly with customers on a principal basis, a broker-dealer violates Exchange Act Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups (as discussed above), without disclosing the fact to the customer. See, e.g., Grandon v. Merrill Lynch & Co., 147 F.3d 184, 189-90 (2d Cir. 1998). See also Exchange Act Rule 10b-10 (requiring a broker-dealer effecting transactions in securities to provide written notice to the customer of certain information specific to the transaction at or before completion of the transaction, including the capacity in which the broker-dealer is acting (i.e., agent or principal) and any third party remuneration it has received or will receive).

By contrast, the Advisers Act has been described as a more principles-based approach.[469] Although some Advisers Act provisions and rules impose specific requirements and prohibitions, the Advisers Act governs an adviser's standard of conduct in providing advice to its clients through the fiduciary duty recognized under Advisers Act Section 206(1) and (2). Under that duty, an adviser must eliminate, or at least disclose, all conflicts of interest that might incline an adviser to render advice that is not disinterested.[470]

Differences in the regulation of broker-dealers and investment advisers are a consequence of the historically different functions and activities of investment advisers and broker-dealers and different governing statutes. Some differences in regulation (e.g., rules regarding underwriting or market making) primarily reflect the different functions and business activities of investment advisers and broker-dealers, whereas other differences may reflect statutory differences, particularly when differences occur when broker-dealers and investment advisers are engaging in the same activity (i.e., providing personalized investment advice or recommendations about securities to retail investors). While the former may not result in substantive differences in investor protection and may allow for diversity of products or services and investor choice, the latter, to the extent they exist, could be exploited by the industry through regulatory arbitrage and, in any event, may need to be addressed in order to improve the effectiveness of both regimes by providing more consistent protections to investors and reducing investor confusion.

Many commenters addressed what they believed to be current gaps, shortcomings or overlaps in existing investment adviser and broker-dealer regulation and suggested several potential areas of regulatory harmonization or improvement. These suggestions include, among others, the following general areas: disclosure;[471] registration, licensing,

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469 See, e.g., IAA Letter, supra note 462.

470 See Capital Gains, supra note 82. See also IAA Letter, supra note 462.

471 See, e.g., ACLI Letter, supra note 414; letter from Kevin R. Keller, Chief Executive Officer, Certified Financial Planner Board of Standards, Inc., Marvin W. Tuttle, Jr., Executive Director/Chief Executive Officer, Financial Planners Association, and Ellen Turf, Chief Executive Officer, National Association of Personal Financial Advisors, dated Aug. 30, 2010 (collectively, "Financial Planning Coalition Letter"); letter from Karrie McMillan, General Counsel, Investment Company Institute, dated Aug. 30, 2010 ("ICI Letter"); letter from Dale E. Brown, President and Chief Executive Officer, Financial Services Institute, dated Aug. 30, 2010 ("FSI Letter"); letter from Jason Berkowitz, Director and Counsel, Regulatory Affairs, The Hartford Financial Services Group, Inc., dated Aug. 30, 2010 ("Hartford Letter"); letter from Stephanie L. Brown, Managing Director and General Counsel, LPL Financial Corp., dated Aug. 30, 2010 ("LPL Letter"); letter from Cheryl L. Tobin, Assistant Vice President & Insurance Counsel, Pacific Life, dated Aug. 30, 2010 ("Pacific Life Letter"); letter from Colleen Van Dyke, Vice President, State Farm VP Management Corp., dated Aug. 27, 2010 ("SFVPMC Letter"); letter from Patrick H. McEvoy, President and Chief Executive Officer, Woodbury Financial Services, Inc., dated Aug., 30, 2010 ("Woodbury Letter"); ABA & ABASA Letter, supra note 21; Ameriprise Letter, supra note 39; CAI Letter, supra note 26; letter from Marc Menchel, Executive Vice President and General Counsel, FINRA, dated Aug. 25, 2010 ("FINRA Letter"); IAA Letter, supra note 462; Schwab Letter, supra note 19.

competency and continuing education;[472] obligation to act in the "best interest" of the customer;[473] suitability;[474] oversight and examination;[475] the lack of an investment adviser SRO;[476] the lack of appropriate Commission resources to support an investment adviser examination program;[477] supervision;[478] advertising;[479] books and records;[480] financial responsibility;[481] and investor remedies through a private right of action[482] or arbitration.[483] This section addresses, among others, these points.

The differences and similarities between the two regulatory regimes raise topics of great importance. This section, however, is not intended to provide an exhaustive

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472 See, e.g., letter from August 30, 2010 by David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, dated Aug. 30, 2010 ("AALU Letter"); BOA Letter, supra note 17; FSI Letter, supra note 471; Hartford Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39; Woodbury Letter, supra note 471.

473 See, e.g., Schwab Letter, supra note 19.

474 See, e.g., FSI Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39.

475 See, e.g., AALU Letter, supra note 472; BOA Letter, supra note 17; Financial Planning Coalition Letter, supra note 471; FINRA Letter, supra note 471; FSI Letter, supra note 471; Hartford Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39.

476 See, e.g., letter from Brendan Daly, Legal and Compliance Counsel, Commonwealth Financial Network, dated Aug. 30, 2010 ("Commonwealth Letter"); FINRA Letter, supra note 471; FSI Letter, supra note 471. See also Section 914 Study and Commissioner Walter Statement, supra note 3.

477 See IAA Letter, supra note 462 (recommending bolstering Commission resources to ensure that investment advisers are subject to an effective inspection program) and letter from Richard H. Baker, President and CEO, Managed Funds Association (Sept. 22, 2010) (supporting appropriate fees on investment advisers to help ensure that OCIE has the resources they need to conduct examinations of the investment adviser industry).

478 See, e.g., AALU Letter, supra note 472; CAI Letter, supra note 26.

479 See, e.g., FINRA Letter, supra note 471; FSI Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39.

480 See, e.g., FSI Letter, supra note 471; LPL Letter, supra note 471.

481 See, e.g., BOA Letter, supra note 17; FSI Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39.

482 See, e.g., letter from by Scott R. Shewan, President, Public Investors Bar Association, dated Sept. 3, 2010 ("PIABA Letter").

483 See, e.g., letter from Barbara Black, Charles Hartsock Professor of Law and Director of the Corporate Law Center, University of Cincinnati College of Law, dated Aug. 16, 2010 ("Black Letter"); FSI Letter, supra note 471; Financial Planning Coalition Letter, supra note 471; Hartford Letter, supra note 471; Woodbury Letter, supra note 471.

treatise or to articulate new staff positions in either area of regulation and should be read against the background of the detailed descriptions of each regulatory regime in Section II.B. Rather, the discussion below focuses on identifying, in accordance with the mandate in Dodd-Frank Act Section 913, selected differences in the standard of conduct and specific other areas that the Staff recommends that the Commission consider addressing through rulemaking, interpretive guidance, or recommendations for legislative change.

B. Standards of Conduct

The overall legal standards of conduct for broker-dealers and investment advisers have differing and complex histories. Both sets of standards evolved in large part under the general antifraud provisions of the respective federal securities laws, but with differing applications and differing results to different industries. On the broker-dealer side, the standard has developed substantially through a number of specific Commission and FINRA rules, disclosure requirements, interpretations by the Commission and its staff and FINRA, as well as case law, numerous SRO disciplinary actions, and Commission enforcement actions. On the adviser side, the standard has developed primarily through Commission and staff interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions.[484]

A core difference, observed by many commentators and commenters, is that investment advisers are fiduciaries under the federal securities laws, while broker-dealers generally are not.[485] The Commission has stated that the fiduciary duty of investment advisers includes a duty of loyalty and a duty of care (encompassing, among other things, a duty of suitability), with the duty of loyalty requiring investment advisers to act in the best interests of clients and to avoid or disclose conflicts. The standard of conduct for broker-dealers has been characterized as primarily to deal fairly with customers and to observe high standards of commercial honor and just and equitable principles of trade, and they also are subject to a number of specific obligations, including a duty of suitability, as well as requirements to disclose certain conflicts. In practice, with broker-dealers, required disclosures of conflicts have been more limited than with advisers and apply at different points in the customer relationship.[486]

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484 See Section II.B.1, supra.

485 While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. See Section II.B.2 for a discussion of the circumstances under which a broker-dealer may be held to a fiduciary duty.

486 See supra Section II.B.2 for a discussion of a broker-dealer's obligation to disclose conflicts of interests.

The Staff believes that these differences in the standard of conduct are significant and are not well understood by retail customers, as the RAND Report and many commenters observed. The Staff believes that investors generally expect that an investment professional is acting in their best interests and that they should not have to parse the title on a business card or other information to assess whether the professional has their best interests at heart.[487] Therefore, in the interests of increasing investor protection and reducing investor confusion, the Staff recommends that both broker-dealers and investment advisers should be held to a uniform fiduciary standard in providing personalized investment advice about securities to retail customers that is no less stringent than the existing fiduciary standard of investment advisers under Advisers Act Sections 206(1) and (2). The Staff believes that the uniform fiduciary standard would be consistent with the standard and precedent that apply to investment advisers.

Many commenters supported a uniform standard of conduct in some form for investment advisers and broker-dealers providing personalized investment advice about securities to retail customers. These commenters include investors' advocates,[488] trade groups,[489] state regulators,[490] government officials,[491] a self-regulatory organization,[492] industry representatives (including investment advisers, broker-dealers, and dually registered firms),[493] coalition groups,[494] academics,[495] investors[496] and other individuals.[497]

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487 See, e.g., Section III supra, discussing investors' confusion with respect to whether their financial services firm is a broker-dealer or an investment adviser.

488 See, e.g., AARP Letter, supra note 449 (adopt a fiduciary duty for any financial professional providing investment advice to retail investors); CFA Letter, supra note 450 (supports requiring broker-dealers to meet the same fiduciary standard (i.e., Advisers Act obligations) to which all other investment advisers are held when they provide personalized investment advice and recommend securities); PIABA Letter, supra note 482.

489 See, e.g., ABA & ABASA, supra note 21; letter from The Committee for the Fiduciary Standard, dated Aug. 20, 2010; Financial Planning Coalition Letter, supra note 471 (supporting the establishment of a strong and uniform fiduciary standard of conduct, consistent with the standard currently applied to investment advisers under the Advisers Act, for all financial professionals who provide personalized investment advice to retail customers); FSI Letter, supra note 471; IAA Letter, supra note 462 (supporting the fiduciary duty standard under the Advisers Act); ICI Letter, supra note 471; letter from William T. Baldwin, et al, National Association of Personal Financial Advisors, dated Aug. 30, 2010 ("NAPFA Letter"); SIFMA Letter, supra note 25.

490 See, e.g.. letter from William F. Galvin, Secretary of the Commonwealth, Commonwealth of Massachusetts, dated Aug. 31, 2010; NASAA Letter, supra note 428 (advocating that the standard should be the fiduciary duty currently applicable to investment advisers under the Advisers Act).

491 See, e.g., letter from U.S. Senators Daniel K. Akaka and Robert Menendez, dated Aug. 30, 2010.

492 See FINRA Letter, supra note 471.

493 See, e.g., Ameriprise Letter, supra note 39; BOA Letter, supra note 17 (supporting a "new, fiduciary standard of care" that requires financial professionals to act in an individual investor's best interest when providing personalized investment advice); Hartford Letter, supra note 471;

In light of the concerns noted above, and consistent with Congress's grant of authority in Section 913, the Staff recommends that the Commission propose rules that would apply expressly and uniformly to both broker-dealers and investment advisers, when providing investment advice about securities to retail customers, [498] a fiduciary standard no less stringent than currently applied to investment advisers under Advisers Act Sections 206(1) and (2). In particular, the Staff recommends that the Commission exercise its rulemaking authority under Dodd-Frank Act Section 913(g), which permits the Commission to promulgate rules to provide that:

Janney Letter, supra note 30 ("Janney therefore welcomes any new uniform standard of conduct that provides clarity to customers and promotes investor protection."); LPL Letter, supra note 471 (supporting a uniform standard of conduct based on fiduciary principles under the law of agency, in particular requiring firms to act loyally for the client's benefit in all matters connected with relationship, using the same care, competence and diligence that a prudent person would exercise in similar circumstances."); Morgan Stanley Letter, supra note 39; Schwab Letter, supra note 19; letter from Adym W. Rygmyr Associate General Counsel, TIAA-CREF Individual & Institutional Services, LLC, dated Aug. 27, 2010 ("TC Services Letter"); Wells Fargo Letter, supra note 17 ("The fiduciary duty adopted for broker-dealers when providing personalized investment advice regarding securities to retail clients resulting in transactions for compensation should be based primarily on the existing standard developed under the Investment Advisers Act of 1940 (the "Advisers Act"), which generally provides that investment management professionals be loyal to clients and act in clients' best interests."); Woodbury Letter, supra note 471.

494 See, e.g., letter from Alex Grodin, Americans for Financial Reform, dated Aug. 30, 2010.

495 See, e.g., letter from James J. Angel, Associate Professor of Finance, Georgetown University McDonough School of Business, dated Oct. 24, 2010 ("If the product sold is that of advice, then the appropriate standard should be that of a fiduciary and that advice should be in the best interest of the client. Anything else is fraud, because the seller is delivering a service different from what the consumer thinks he or she is buying."); Black Letter, supra note 483 (supporting a uniform standard of conduct and competence based on professionalism).

496 See, e.g., letter from Robert J. Ziner, dated Aug. 27, 2010; letter from Mel Turner, dated Aug. 29, 2010; letter from Joel E. Fried, dated Aug. 29, 2010; letter from Ralph W. Geuder, dated Aug. 29. 2010; letter from Donald A. Flory, dated Aug. 29, 2010; letter from Frank J Udvarhely, dated Aug. 29, 2010.

497 See, e.g., letter from Tony Camp, dated Aug. 30, 2010; letter from Rita A. Lehr, dated Aug. 31, 2010; letter from Frank Hoefert, Certified Financial Analyst, dated Aug. 30, 2010; letter from Roxanne E. Flesza, President of Financial Resources Management Corp., dated Aug. 30, 2010; letter from Jennifer C. Ragborg, dated Aug. 30, 2010; letter from Ron Rhoades, Director of Research, Chief Compliance Officer, Joseph Capital Management, dated Aug. 30, 2010 (arguing for the uniform imposition of the bona fide fiduciary standard of conduct currently found in the Advisers Act).

498 The Exchange Act uses the the word "customer" and the Advisers Act uses the word "client" to designate the investors served by broker-dealers and investment advisers, respectively. This discussion generally refers to both categories of investors as retail customers, using the defined term under Dodd-Frank Act Section 913.

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

The standard outlined above is referred to in the Study as the "uniform fiduciary standard."

The uniform fiduciary standard would apply to broker-dealers and investment advisers under the new authority in Exchange Act Sections 15(k) and Advisers Act Section 211(g). Therefore, the recommended uniform fiduciary standard and the related discussion below would not have any direct bearing on other persons who may be characterized as fiduciaries in other areas of the law, including ERISA fiduciaries or financial institutions such as banks and trust companies.[499] The Staff also contemplates that the uniform fiduciary standard would be an overlay on top of the existing investment adviser and broker-dealer regimes and would supplement them, and not supplant them.[500]

The Staff considered a number of alternative approaches to the uniform fiduciary standard.[501] The Staff ultimately concluded that the uniform fiduciary standard, as outlined above and described in further detail below, would be the most appropriate standard. It addresses investor confusion and promotes integrity of advice by applying the same fiduciary standard to the provision of personalized investment advice about securities, whether that advice is provided by a broker-dealer or investment adviser. At the same time, it balances concerns about the impact of regulatory change on investor access to low-cost products and services by not per se eliminating particular products, services, or compensation schemes.

Recommendation: The Commission should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

> ***the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail***

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499 See, e.g., UBS Letter, supra note 39; BOA Letter, supra note 17.

500 Therefore, investment advisers and broker-dealers would continue to be subject to their current regulatory requirements, and the Commission could consider as part of implementing the uniform fiduciary standard whether to impose additional requirements, through rulemaking and/or guidance, as discussed below.

501 For example, as further discussed below, the Staff considered whether to recommend eliminating the broker-dealer exclusion from the definition of "investment adviser" under Advisers Act Section 202(a)(11).

customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

C. Implementing the Uniform Fiduciary Standard

The description of the standard as fiduciary is by itself only a general characterization. Justice Cardozo wrote in a famous Supreme Court decision: "But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry."[502] The discussion below seeks to provide that "further inquiry" in the context of advisers and broker-dealers. The discussion describes the details of the uniform fiduciary standard that the staff recommends the Commission specify in any rulemaking and/or interpretive guidance.

The uniform fiduciary standard would require broker-dealers and investment advisers to act in the best interest of retail customers without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. Commenters have raised questions about the definition of "best interest."[503] Many commenters called for specific and clear rules and guidance about the extent to which, and when, any uniform fiduciary standard would apply,[504] and commenters offered different definitions of the "best interest" standard.

Dodd-Frank Act Section 913(g) provides that any rules that the Commission promulgates under the uniform fiduciary standard "shall provide that such standard of conduct shall be no less stringent that the standard applicable to investment advisers under Section 206(1) and (2) of [the Advisers] Act when providing personalized investment advice about securities…."[505] The Staff interprets the uniform fiduciary standard to include

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502 SEC v. Chenery Corp., 318 U.S. 80, 84-85 (1943).

503 See, e.g., letter from Andrew McMahon, Chairman of the Board, AXA Advisors, LLC, and Senior Executive Vice President, AXA Equitable Life Insurance Company, dated Aug. 30, 2010 ("AXA Letter"); letter from Joan Hinchman, Executive Director, President and Chief Executive Officer, National Society of Compliance Professionals, dated Aug. 30, 2010 ("NSCP Letter").

504 See, e.g., ABA & ABASA Letter, supra note 21; ACLI Letter, supra note 414; AXA Letter, supra note 503; FSI Letter, supra note 471; ICI Letter, supra note 471; letter from Nicole S. Jones, General Counsel, Lincoln Financial Group, dated Aug. 30, 2010; NSCP Letter, supra note 503; SIFMA Letter, supra note 25; UBS Letter, supra note 39. Cf. NAPFA Letter, supra note 489 (stating that the fiduciary standard as it currently exists under the Advisers Act is clear and well-established).

505 See Dodd-Frank Act Section 913(g)(1) and 913(g)(2). Further, Section 913(g) provides that "[i]n accordance with such rules, any material conflicts of interests shall be disclosed and may be consented to by the customer." Id.

at a minimum, the duties of loyalty and care as interpreted and developed under Sections Advisers Act Section 206(1) and 206(2).[506]

The Staff is of the view that the existing guidance and precedent[507] under the Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply to investment advisers and be extended to broker-dealers, as applicable, under the uniform fiduciary standard.

In addition, the Staff believes that rulemaking and/or interpretive guidance regarding the uniform fiduciary standard would be useful to both investment advisers and broker-dealers, but that such rulemaking and/or interpretive guidance would be especially beneficial for broker-dealers, who may not be as familiar with the application of the uniform fiduciary standard to advice-giving activities. Therefore, any Commission rulemaking or guidance relating to the uniform fiduciary standard should particularly focus on assisting broker-dealers with complying with the minimum requirements of the uniform fiduciary standard and what it means to generally operate under the uniform fiduciary standard.

Clarification will be particularly important in applying the obligation to eliminate or at least disclose all material conflicts of interest, as contemplated by the Dodd-Frank Act.[508] With investment advisers, the Commission and Staff have identified numerous conflicts of interest over time through interpretive guidance, rulemakings, enforcement actions and no-action letters.[509] The Staff believes that the Commission should help broker-dealers similarly identify their conflicts of interest as specifically as possible so as to facilitate broker-dealers' smooth transition to compliance with the uniform fiduciary standard.[510] Similarly, the Commission should continue to help advisers further identify their conflicts of interest.

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506 See also the Section 913(g) amendments to the Exchange Act, adding Section 15(h)(1) to the Exchange Act, providing in part that "Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities." and thereby indicating that Congress intended that the duties of care and loyalty be included and enforced under the uniform fiduciary standard.

507 See, e.g., Capital Gains, supra note 82. See also Release 232 and Release 1105, supra note 89.

508 See Dodd-Frank Act Section 913(g)(1) and 913(g)(2) ("[I]n accordance with such rules [establishing the standard of conduct], any material conflicts of interests shall be disclosed and may be consented to by the customer."

509 See, e.g., Release 3060, supra note 67 (revising the adviser brochure requirements and listing throughout examples of material conflicts of interest).

510 See, e.g., IAA Letter, supra note 462 (identifying examples of broker-dealer conflicts potentially affecting advice to retail customers).

The implementation of a uniform standard of conduct would be most effective only if the standard is applied uniformly. Dodd-Frank Act Section 913(h) amended the Exchange Act by adding new Section 15(m), which provides, in part, that the enforcement authority of the Commission for violations of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to retail customers shall include the enforcement authority of the Commission with respect to violations of the standard of conduct applicable to an investment adviser under the Advisers Act, including the authority to impose sanctions for such violations. Exchange Act Section 15(m) also provides that the Commission shall seek to prosecute and sanction violators of the standard of conduct under the Exchange Act to the same extent as it prosecutes and sanctions violators of the standard of conduct applicable to an adviser under the Advisers Act. Dodd-Frank Act Section 913(h) made mirror amendments to the Advisers Act, adding new Section 211(i). Thus, we contemplate that any rules implementing the uniform fiduciary standard would provide, at a minimum, for violations of the standard not involving scienter to the same extent as the Commission currently enforces antifraud violations involving a breach of fiduciary duty under Advisers Act Section 206(2).[511]

Recommendation: The Commission should engage in rulemaking and/or issue interpretive guidance on the components of the uniform fiduciary standard: the duties of loyalty and care. In doing so, the Commission should identify specific examples of potentially relevant material conflicts of interest in order to facilitate a smooth transition to the new standard by broker-dealers and consistent interpretations by broker-dealers and investment advisers. The existing guidance and precedent under the Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply.

1. Duty of Loyalty

A fundamental aspect of the fiduciary standard recognized under the Advisers Act is the duty of loyalty. This duty prohibits an adviser from putting its interests ahead of its clients.[512] Dodd-Frank Act Section 913(g) addresses the duty of loyalty in that it provides that, "[i]n accordance with such rules [that the Commission may promulgate with respect to the uniform fiduciary standard]…any material conflicts of interest shall be disclosed and may be consented to by the customer." The uniform fiduciary standard, by incorporating Advisers Act Section 206(1) and 206(2), would require an investment

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511 SEC v. Steadman, 967 F.2d 636, 643 (D.C. Cir. 1992) (citing Capital Gains, at 191-192, supra note 82). Such rules could enable the Commission to enforce the uniform fiduciary duty of broker-dealers and investment advisers providing personalized investment advice about securities in contexts not involving fraud .

512 See, e.g., Release 3060, supra note 67.

adviser or broker-dealer to eliminate, or provide full and fair disclosure about its material conflicts of interest.[513]

While the duty of loyalty requires a firm to eliminate or disclose material conflicts of interest, it does not mandate the absolute elimination of any particular conflicts, absent another requirement to do so. Thus, Dodd-Frank Act Section 913(g) expressly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities does not, in and of itself, violate the uniform fiduciary standard as applied to a broker-dealer.[514] It also provides that the uniform fiduciary standard shall not require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice. Moreover, as discussed below, while the uniform fiduciary standard would affect certain aspects of principal trading, it would not in itself impose the principal trade provisions of Advisers Act Section 206(3) on broker-dealers. In addition, Dodd-Frank Act Section 913 provides that offering only proprietary products by a broker-dealer shall not, in and of itself, violate the uniform fiduciary standard, but may be subject to disclosure and consent requirements.

These provisions and others should address a number of concerns from broker-dealers that the standard of conduct should be "business model-neutral,"[515] i.e., that the standard should not prohibit, mandate or promote particular types of products or business models. They also make clear that the implementation of the uniform fiduciary standard should preserve investor choice among such services and products and how to pay for these services and products (e.g., by preserving commission-based accounts, episodic advice, principal trading and the ability to offer only proprietary products to customers).[516]

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513 See Capital Gains, supra note 82; Release 4048, supra note 244. The regulatory approaches to disclosures for investment advisers and broker-dealers are discussed in detail in Section II.B.

514 See Dodd-Frank Act Section 913(g) amendments to the Exchange Act and the Advisers Act, adding Exchange Act Section 15(k)(1) and Advisers Act Section 211(g)(1). The amendments to the Advisers Act contain a similar provision with respect to the receipt of compensation "based on commission or fee" by a "broker, dealer or investment adviser." Id. The Staff reiterates, however, that as discussed infra, to the extent an investment adviser is receiving commissions or other transaction-based compensation, it would need to consider the need to register as a broker-dealer under the Exchange Act, unless an exception or exemption from registration applies. See Section II.B., supra.

515 See, e.g., AXA Letter, supra note 503; ACLI Letter, supra note 414; Hartford Letter, supra note 471; Lincoln Letter, supra note 504; SIFMA Letter, supra note 25.

516 See, e.g., ABA & ABASA Letter, supra note 21; ACLI Letter, supra note 414; AXA Letter, supra note 503; BOA Letter, supra note 17; letter from Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable, dated Aug. 30, 2010; FSI Letter, supra note 471; Hartford Letter, supra note 471; ICI Letter, supra note 471; Janney, supra note 30; Lincoln Letter, supra note 504; NSCP Letter, supra note 503; SIFMA, supra note 25; UBS, supra note 39; Wells Fargo Letter, supra note 17; Woodbury Letter, supra note 471.

a) Disclosure

At the level of the firm, investment advisers and broker-dealers currently are subject to different disclosure requirements. Notably, investment advisers must provide clients and prospective clients with a current firm brochure before or at the time an adviser enters into an advisory contract with the client.[517] The firm brochure (Part 2A of Form ADV) is required to contain information about the investment adviser's services, certain conflicts of interest, and other information including its range of fees, methods of analysis, investment strategies and their risk of loss, brokerage (including trade aggregation policies and directed brokerage practices, as well as the use of soft dollars), review of accounts, client referrals and other compensation, and the adviser's disciplinary and financial information.

Broker-dealers also must make a variety of disclosures, but the extent, form and timing of the disclosures are different. They are not subject to a comparable requirement for a general disclosure of conflicts at the time the relationship is established, as well as other information contained in the investment adviser brochure.[518] Instead, when recommending a security, they generally are required to disclose (though not in writing) any material adverse facts or material conflicts of interest, including any economic self-interest, so that customers may evaluate their overlapping motivations.[519] Broker-dealers also are required to make certain specific disclosures, such as whether they are acting as market makers for a recommended security,[520] or if they have any other control, affiliation or interest in the security.[521] In executing customer trades, broker-dealers must

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[517] See Release 3060, supra note 67 and Advisers Act Rule 204-3. However, investment advisers are not limited to the disclosure requirements of Form ADV, and should disclose all material facts and conflicts of interest consistent with their fiduciary obligations. See Release 3060, id.

Recently, FINRA requested comment on a concept proposal to require the provision of a disclosure statement for retail investors at or before commencing a business relationship that would include many items of information analogous to what is required in Form ADV Part 2. FINRA, Regulatory Notice 10-54, "Disclosure of Services, Conflicts and Duties" (Oct. 2010). Specifically, the proposal would require member firms to provide to a retail customer, at or prior to commencing a business relationship, a written statement describing, among other things: the types of accounts and services it provides; the scope of services provided and products offered to retail customers and the fees associated with each brokerage account and service offered; the conflicts associated with such services (e.g., financial or other incentives that the firm or its registered representatives have to recommend certain products, investment strategies or services) and conflicts that may arise and how the firm manages such conflicts; and any limitations on the duties otherwise owed to retail customers (e.g., not assuring the ongoing suitability of an investment or a portfolio of investments nor the propriety of unsolicited orders, and may execute transactions on a principal basis (absent instructions to act only in an agency capacity)).

[519] See discussion infra Section II.B and accompanying text.

[520] See Chasins, supra note 250 (applying shingle theory, court found broker-dealer impliedly represents that it will disclose market making capacity).

[521] See Exchange Act Rules 15c1-5 and 15c1-6 and SRO rules (e.g., NASD Rules 2240 and 2250; MSRB Rule G-22; and NYSE Rule 312(f)).

provide customers with specific disclosure in confirmation statements at or before the completion of the transaction, including the price at which the trade was executed, the capacity in which a broker acted (i.e., as principal or agent), and the compensation it received, including any compensation it received from third parties.[522]

At the level of the representative or associated person, there are also differences in the information provided or available to retail customers. Investment advisers must provide clients with a brochure supplement (Part 2B of Form ADV), which includes information about certain advisory personnel upon whom clients rely for investment advice, including educational background, supervision, disciplinary history, and certain conflicts. In addition, basic information about adviser personnel who have registered with one or more states as investment adviser representatives is available through the IAPD. Information about persons associated with broker-dealers is available online through FINRA's BrokerCheck website; that information is not as extensive as the information provided in the adviser brochure supplement and more comparable to that available in the IAPD. Dodd-Frank Act Section 919B separately requires a study "of ways to improve the access of investors to registration information (including disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information)" about broker-dealers, investment advisers and their associated persons.

Commenters frequently cited disclosure as an area where the Commission could consider improvement and harmonization of existing requirements.[523] Commenters generally suggested that "key information" that should be provided to investors includes: the services and products provided (including any limits on the range of products offered); the duties and obligations of the broker-dealer or investment adviser; any limitations on the nature and anticipated duration of the relationship; any material conflicts of interest, including descriptions of the types of fees, costs, and incentives associated with the products and services offered and how associated persons are compensated; and any disciplinary history.[524]

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522 See Exchange Act Rule 10b-10 and related discussion in Section II.B.2. As discussed in Section II.B supra, Rule 10b-10 is not a safe harbor from the antifraud provisions. It is important to note, however, that the disclosure is made after the investment decision.

523 See, e.g., ABA & ABASA Letter, supra note 21; ACLI Letter, supra note 414; Ameriprise Letter, supra note 39; CAI Letter, supra note 26; Financial Planning Coalition Letter, supra note 471; FINRA Letter, supra note 471; FSI Letter, supra note 471; Hartford Letter, supra note 471; IAA Letter, supra note 462; ICI Letter, supra note 471; LPL Letter, supra note 471; Pacific Life, supra note 471; Schwab Letter, supra note 19; SFVPMC Letter, supra note 471; supra note 471. But see letter from Knut A. Rostad, The Committee for a Fiduciary Standard, dated Dec. 21, 2010 ("Reliance on casual disclosures, alone, is the opposite of reliance on the fiduciary professional's recommendation, and negates the very purpose of the fiduciary standard.").

524 See, e.g., ACLI Letter, supra note 414; Financial Planning Coalition Letter, supra note 471; IAA Letter, supra note 462; ICI Letter, supra note 471; letter from Thomas C. Blank, General Counsel, Association of Independent Trust Companies, Inc., dated Aug. 30, 2010.

For the uniform fiduciary standard to be effective, investors need to understand any material conflicts of interest of their investment adviser or broker-dealer. The Staff also believes that other information about the scope of their relationships with their investment advisers or broker-dealers would be helpful to retail customers. Dodd-Frank Act Section 913(g) recognizes the importance of such disclosure, and directs the Commission to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest."[525]

Therefore, the Staff recommends that the Commission consider developing a uniform approach to disclosure that would provide retail customers of both broker-dealers and investment advisers with relevant key pieces of information at the outset of the advisory or brokerage relationship and at appropriate times thereafter. This presumably would include extending to broker-dealers a requirement of a general relationship disclosure document analogous to Form ADV Part 2 at or prior to account opening.

Moreover, as discussed above, retail customers do not always understand the roles of investment advisers and broker-dealers,[526] and may be confused by financial or legal terms.[527] In addition, too much information can overwhelm retail customers, and may lead them to miss important information or ignore disclosure altogether.[528] Therefore, the Staff recommends that the Commission consider as part of any uniform disclosure document how to communicate key information in a simple, clear and concise way.[529] In particular, the Staff recommends that the Commission explore the utility and feasibility of a summary disclosure document that would describe in clear, summary form, a firm's services (including the extent to which its advice is limited in time or is continuous and ongoing), charges, and conflicts of interest.

Another important issue to consider is the timing of customer disclosure. The Staff believes that retail customers would benefit from receiving certain disclosures, such

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525 Section 913(g) also provides that "[i]n accordance with such rules, any material conflicts of interests shall be disclosed and may be consented to by the customer."

526 For example, customers may believe that their financial services provider is monitoring their accounts (like investment advisers with discretionary authority), when the provider may not generally do so unless specifically contracted.

527 See, e.g., the RAND Report, supra note 454.

528 See Office of Investor Education and Assistance, U.S. Securities and Exchange Commission, A Plain English Handbook: How to Create Clear SEC Disclosure Documents (Aug. 1998) (discussing the importance of clear, simple wording in disclosure documents so as not to overwhelm an investor). As part of its recommendations, the Staff recommends considering additional investor education outreach as an important complement to the uniform fiduciary standard. See Section IV.C.4 below.

529 See, e.g., ABA and ABASA Letter, supra note 21; ACLI Letter, supra note 414; CAI Letter, supra note 26; FSI Letter, supra note 471; Schwab Letter, supra note 19; SIFMA Letter, supra note 25.

as information about the firm's conflicts of interest, fees, scope of services, and disciplinary information, before or at the time of entering into a customer relationship, with annual updating disclosures thereafter (as is the case with Form ADV Part 2A). Other disclosures about a product, risks, compensation or any specific conflicts could be more effective at the point when personalized investment advice is given.

Some commenters were concerned that investment advisers and broker-dealers might seek to "disclose away" conflicts of interest under the uniform fiduciary standard.[530] The uniform fiduciary standard, because it must be "no less stringent than" Advisers Act Sections 206(1) and 206(2), would ensure that the basic protections regarding conflicts of interest currently available under the Advisers Act would be preserved and would not be watered down.[531] The Staff believes that it is the firm's responsibility—not the customers'—to reasonably ensure that any material conflicts of interest are fully, fairly and clearly disclosed so that investors may fully understand them.[532] To this end, however, the Commission could consider whether rulemaking would be appropriate to prohibit certain conflicts, or where it might be appropriate to impose specific disclosure and consent requirements (e.g., in writing and in a specific format, and at a specific time) in order to better assure that retail customers were fully informed and can understand any material conflicts.

Recommendation: The Commission should facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest. The Commission should consider the disclosures that should be provided (a) in a general relationship guide akin to the new Form ADV Part 2A that advisers deliver at the time of entry into the retail customer relationship, and (b) in more specific disclosures at the time of providing investment advice (e.g., about certain transactions that the Commission believes raise particular customer protection concerns). The Commission also should consider the utility and feasibility of a summary disclosure document containing key information on a firm's services, fees, and conflicts and the

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530 See CFA Letter, supra note 450. See also Financial Planning Coalition Letter, supra note 471; NAPFA Letter, supra note 489; letter from Ron A. Rhoades, dated Dec. 20, 2010; letter from Knut Rostad, Chairman, The Committee for the Fiduciary Standard, dated Dec. 21, 2010.

531 See Instruction 3 of General Instructions to Part 2 of Form ADV, explaining that advisers must provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest the adviser has and the business practices in which it engages, and can give his or her informed consent to the transaction or practice that gives rise to the conflict or to reject the transaction or practice.

532 Cf. letter from Ron A. Rhoades dated Dec. 20, 2010 ("The burden is upon the investment adviser to reasonably ensure client understanding") ("Rhoades Letter 2"); Financial Planning Coalition Letter, supra note 471 ("It is not sufficient for a firm or an investment professional to make full disclosure of potential conflicts of interest with respect to such products [e.g., collateralized debt obligations and structured products]. The firm and the investment professional must make a reasonable judgment that the client is fully able to understand and evaluate the product and the potential conflicts of interest that it presents.").

scope of its services (e.g., whether its advice and related duties are limited in time or are ongoing). The Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements.

b) Principal Trading

Principal trading raises concerns because of the risks of price manipulation or the placing of unwanted securities into client accounts (i.e., "dumping"). Engaging in principal trading with customers or clients represents a clear conflict for any fiduciary. Advisers Act Section 206(3) prohibits an adviser from engaging in a principal trade with an advisory client, unless it discloses to the client in writing before completion of the transaction the capacity in which the adviser is acting and obtains the consent of the client to the transaction.[533] The Commission has interpreted the reference to "the transaction" to require separate disclosure and consent for each transaction.[534] To this end, an investment adviser must provide written disclosure to a client and obtain the client's consent at or prior to the completion of each transaction.[535] As the Commission has stated, "[i]n adopting Section 206(3), Congress recognized the potential for [abuses such as price manipulation or the placing of unwanted securities into client accounts], but did not prohibit advisers entirely from engaging in all principal and agency transactions with clients. Rather, Congress chose to address these particular conflicts of interest by

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533 On December 28, 2010, the Commission amended Advisers Act Rule 206(3)-3T, a temporary rule that establishes an alternative means for investment advisers that are registered with the Commission as broker-dealers to meet the requirements of Advisers Act Section 206(3) when they act in a principal capacity in transactions with certain of their advisory clients. Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 3128 (Dec. 28, 2010) ("Release 3128"). The amendment extended the date on which Rule 206(3)-3T will sunset from December 31, 2010 to December 31, 2012. The Commission stated in the adopting release that "firms' compliance with the substantive provisions of rule 206(3)-3T provides sufficient protection to advisory clients to warrant the rules continued operation while we conduct the study mandated by section 913 of Title IX of the Dodd-Frank Act and consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers." Release 3128 at 4. The Commission also noted that, as part of its broader consideration of regulatory requirements applicable to broker-dealers and investment advisers, it "intend[s] to carefully consider principal trading by advisers, including whether rule 206(3)-3T should be substantively modified, supplanted, or permitted to expire." Release 3128 at 5.

534 See Release 40, supra note 99 ("[T]he requirements of written disclosure and of consent contained in this clause must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice.").

535 Release 1732, supra note 98 ("Implicit in the phrase 'before the completion of such transaction' is the recognition that a securities transaction involves various stages before it is 'complete.' The phrase 'completion of such transaction' on its face would appear to be the point at which all aspects of a securities transaction have come to an end. That ending point of a transaction is when the actual exchange of securities and payment occurs, which is known as 'settlement.'").

imposing a disclosure and client consent requirement in Section 206(3) of the Advisers Act."[536]

By contrast, broker-dealers may engage in principal transactions with customers, subject to a number of requirements, including that they disclose their capacity in the transactions (typically on the confirmation statement),[537] seek to obtain best execution for principal transactions when a broker-dealer accepts an order from a customer,[538] make only suitable recommendations, and charge customers fair and reasonable prices and commissions.[539] There is no specific requirement for written disclosure or explicit consent for each principal transaction.[540]

Dodd-Frank Act Section 913(g) requires that the standard of conduct applicable to broker-dealers should be "no less stringent" than Advisers Act Section 206(1) and (2), and does not refer to Advisers Act Section 206(3). The omission of a reference to Section 206(3) appears to reflect a Congressional intent not to mandate the application of that provision to broker-dealers when providing personalized investment advice about securities to retail investors (though granting the Commission the authority to impose such restrictions). Many commenters have expressed concerns about how principal trading would be regulated under the uniform fiduciary standard.[541] In particular, broker-dealers and dual registrants noted that some types of securities, such as municipal and corporate bonds, new issues, and proprietary products, are typically traded and initially offered on a principal basis.[542]

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536 See Release 1732, supra note 98 at text accompanying note 5. Commenters have suggested a number of changes to the Advisers Act principal trading regime. See, e.g., IAA Letter, supra note 462 ("We recognize that there may be facts and circumstances under which it is appropriate for the SEC to provide relief pursuant to its broad exemptive authority under Advisers Act section 206A. Regardless of whether the specific prophylactic provisions of section 206(3) apply, however, as fiduciaries, broker-dealers would be required to provide full and fair disclosure regarding the practice to clients, adopt policies and procedures to address the conflict, and ensure that a principal trade is fair and in the best interest of clients" (citations omitted)). But see letter from Ellen Turf, CEO, NAPFA, letter dated Dec. 20, 2010 (expressing concerns about the Commission's extension of Rule 206(3)-3T).

537 See Exchange Act Rule 10b-10.

538 See, e.g., Regulation NMS Release; NASD Rule 2320 ("Best Execution and Interpositioning"). See also discussion of a broker-dealer's best execution obligations, infra Section II.B.

539 See NASD Rule 2440 (Fair Prices and Commissions), IM-2440-1 (Mark-Up Policy), and IM-2440-2 (Mark-Up Policy for Debt Securities). See also discussion of a broker-dealer's obligations with respect to fair prices, commissions, and charges, infra Section II.B.

540 See note 533 supra, for a discussion of the principal trading rules applicable to dual registrants.

541 See, e.g., ABA & ABASA Letter, supra note 21; BOA Letter, supra note 17; FINRA Letter, supra note 471; Janney Letter, supra note 30; SIFMA Letter, supra note 25; and Wells Fargo Letter, supra note 17.

542 See, e.g., BOA Letter, supra note 17; SIFMA Letter, supra note 25; Wells Fargo Letter, supra note 17.

Principal trades by broker-dealers raise the same potential conflicts of interest as such trades by investment advisers and thus implicate the duty of loyalty included in the uniform fiduciary standard. Therefore, under the uniform fiduciary standard, a broker-dealer should be required, at a minimum, to disclose its conflicts of interest related to principal transactions, including its capacity as principal, but it would not necessarily be required to follow the specific notice and consent procedures of Advisers Act Section 206(3). Of course, when engaging in principal transactions, broker-dealers would remain subject to obligations relating to suitability, best execution, and fair and reasonable pricing and compensation.[543]

The Staff recommends that the Commission address through guidance or rulemaking how broker-dealers would fulfill the uniform fiduciary standard when engaging in principal trades. We understand that this issue is particularly consequential with respect to fixed income securities, including municipal bonds. The Commission could at the same time consider whether any changes should be made to the principal trading requirements that apply to investment advisers.[544] For example, the Commission could consider the type of information (and when it is provided) that would be most useful to investors to help them understand what a principal trade means and the potential risks and benefits. The Staff believes, however, that the uniform fiduciary standard would require broker-dealers and investment advisers provide sufficiently specific facts so that investors are able to understand the conflicts of interest. In this regard, the Staff believes that requests for consent embedded in voluminous advisory agreements or other account opening agreements would impede the provision of such consent.

Recommendation: The Commission should address through guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.

2. Duty of Care

As discussed above, another fundamental aspect of the fiduciary standard recognized under the Advisers Act is the duty of care.[545] An investment adviser's duty of care requires it to "make a reasonable investigation to determine that it is not basing its

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543 See Section II.B for a discussion of a broker-dealer's disclosure obligations.

544 At that time, the Staff believes that the Commission should also consider addressing potential conflicts of internalization and other practices that may be analogous to "agency cross" trades, which Advisers Act Section 206(3) prohibits along with principal trades. These are trades in which an adviser, "acting as a broker for a person other than such client" knowingly effects a sale or purchase of a security for the account of a client. The Commission's exemption for certain agency cross trades in Advisers Act Rule 206(3)-2 reflects a policy determination that certain, limited agency cross trades do not raise the same potential conflict concerns as principal trades.

545 See, e.g., Release 2106, supra note 85.

recommendations on materially inaccurate or incomplete information."[546] The duty of care also obligates investment advisers to seek best execution of clients' securities transactions when they have the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts).[547] A broker-dealer is subject to explicit rules and guidance that establish minimum, unwaivable obligations to: (1) reasonably believe that its securities recommendations are suitable for its customer in light of the customer's financial needs, objectives and circumstances, and comply with specific disclosure, due diligence, and suitability requirements for certain securities products;[548] (2) seek to execute customers' trades at the most favorable terms reasonably available under the circumstances;[549] and (3) charge only prices for securities and compensation for services that are fair and reasonable taking into consideration all relevant circumstances.[550]

A number of commenters (particularly investment advisers) stated that the duty of care obligations under the Advisers Act are clear and well-established.[551] A number of other commenters (particularly broker-dealers) have argued that the duty of care is far more developed for broker-dealers (e.g., the professional standards of conduct developed by FINRA), and that the investment advisers' duty of care is ambiguous.[552] They argued that the lack of detailed rules regarding professional standards of conduct demonstrates a

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546 See Release 3052, supra note 87.

547 See Advisers Act Rule 206(3)-2(c) (acknowledging adviser's duty of best execution of client transactions). See 2006 Soft Dollar Release, supra note 95 (stating that investment advisers have "best execution obligations"). See also Release 3060, supra note 67.

548 See discussion of a broker-dealer's suitability obligations, supra Section II.B.

549 See discussion of a broker-dealer's fair price, commissions and charges obligations, infra Section II.B.

550 See discussion of a broker-dealer's best execution obligations, infra Section II.B.

551 See, e.g., NAPFA Letter, supra note 489.

552 See, e.g., Pacific Life Letter, supra note 471; UBS Letter, supra note 39; Lincoln Letter, supra note 504; AALU Letter, supra note 472; FSI Letter, supra note 471; letter from Bob Rusbuldt, President and Chief Executive Officer, Independent Insurance Agents & Brokers of America, Inc., dated Aug. 30, 2010 ("IIABA Letter"); Letter from Susan B. Waters, Chief Executive Officer, National Association of Insurance and Financial Advisors, dated Aug. 30, 2010 ("NAIFA Letter"); and NSCP Letter, supra note 503. One commenter suggested the following professional standards of conduct be implemented for investment advisers and broker-dealers: prohibition against unauthorized trading; duty of best execution; duty to convey accurate information; suitability; duty to warn (i.e., if a security or strategy entails greater risks than the investor should assume, given his or her financial situation); and duty to monitor when the investment adviser or broker-dealer provides advice on an ongoing basis, including monitoring the account, reassessing periodically the investor's investment objectives and strategy, and, when appropriate, recommending modifications to the investor's portfolio. See Black Letter, supra note 483. But see Dodd-Frank Act Section 913(g), providing that "[n]othing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."

gap in the regulation of investment advisers and broker-dealers.[553] Other commenters argued that the Advisers Act is intended to flexibly accommodate the varying structures, sizes, and natures of advisory businesses, and that detailed proscribed rules are inconsistent with the dynamic nature of fiduciary duty.[554]

The Staff believes that the Commission, through rulemaking, guidance, or both, should specify the minimum professional obligations of investment advisers and broker-dealers under the duty of care. In evaluating the regulation of investment advisers and broker-dealers, the Staff believes that it could be useful to develop rules or guidance on the minimum requirements that are fundamental to a duty of care under the uniform fiduciary standard.

Professional standards under the duty of care could be developed regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice to retail customers. The Commission could articulate and harmonize any such standards, by referring to and expanding upon, as appropriate, the explicit minimum standards of conduct relating to the duty of care currently applicable to broker-dealers (e.g., suitability (including product-specific suitability), best execution, and fair pricing and compensation requirements) under Commission and SRO rules.[555]

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553 See, e.g., ACLI Letter, supra note 414 ("To the extent that the SEC determines that there are gaps with respect to the detailed conduct rules already in place, the SEC should look to specifically address such gaps, as opposed to simply turning, as noted above, to a broad and vague fiduciary standard as some have suggested."); NSCP Letter, supra note 503; Lincoln Letter, supra note 504; letter from Randy F. Wallake, Vice Chair and President, Securian Financial Group, Inc., dated Aug. 27, 2010 ("Securian Letter").

554 See, e.g., IAA Letter; supra note 462 (citing to various Commission releases to demonstrate the Commission's approach over the years); Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256 (July 9, 2004) ("proposal left advisers with substantial flexibility to design individualized codes that would best fit the structure, size and nature of their advisory businesses"); Release 2204, supra note 147 ("Commenters agreed with our assessment that funds and advisers are too varied in their operations for the rules to impose of a single set of universally applicable required elements"); Release 2106, supra note 85 ("Investment advisers registered with us are so varied that a 'one-size-fits-all' approach is unworkable"); ICI Letter, supra note 471; NAPFA Letter, supra note 489 ("While specific rules have been and may be adopted under same, the fiduciary standard must be free to adapt so as to address new forms of improper conduct that seek to get around specific rules."). See also CFA Letter, supra note 450 (arguing that a fiduciary duty is facts and circumstances based, and that it would be impossible to write a rule to cover all the different eventualities that might arise, but noting that this does not mean that neither guidance nor rules could be developed in support of a fiduciary duty).

555 In considering whether and how to develop investment advisers' duty of care, some commenters have pointed to the detailed rules imposed on broker-dealers as a useful framework. See, e.g., Pacific Life Letter, supra note 471; UBS Letter, supra note 39; Lincoln Letter, supra note 504; AALU Letter, supra note 472; FSI Letter, supra note 471; IIABA Letter, supra note 552; NAIFA Letter, supra note 552; and NSCP Letter, supra note 503.

Any such rules or guidance could take into account long-held Advisers Act fiduciary principles, such as the duty to provide suitable investment advice (e.g., with respect to specific recommendations and the client's portfolio as a whole) and to seek best execution.[556] Detailed guidance in this area has not been a traditional focus of the investment adviser regulatory regime.

The Staff recognizes commenters' concerns regarding the difficulties of establishing professional standards of conduct that have enough flexibility to function effectively in a dynamic market to be relevant and to deter new fraudulent schemes. Accordingly, the Staff recommends that any rulemaking or guidance explicitly provide that it establishes only *minimum* expectations for the appropriate standard of conduct and does not establish a safe harbor or otherwise prevent the Commission from applying a higher standard of conduct based on specific facts and circumstances.

Recommendation: The Commission should consider specifying uniform standards for the duty of care owed to retail customers, through rulemaking and/or interpretive guidance. Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to a retail customer.

3. Personalized Investment Advice About Securities

Section 913 does not define the term "personalized investment advice." However, if the uniform fiduciary standard were applied to broker-dealers and investment advisers under Section 913, it would be critical for these firms to understand when it applies, i.e., when providing investment advice about securities to retail customers.

Although the Advisers Act does not separately define "investment advice," it does define the term "investment adviser,"[557] which is fundamental to the scope of the Advisers Act. The Commission and staff have interpreted the term in detail on several occasions.[558] The Commission also has defined some services that investment advisers may provide as "impersonal investment advice," which means "investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts."[559] The determination of whether a particular communication rises to the level of investment advice or "impersonal investment advice" depends on the facts and circumstances.

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556 See supra note 109 (proposed by the Commission but not adopted).

557 The term "investment adviser" is defined as a person who "engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." Advisers Act Section 202(a)(11).

558 See, e.g., Release 1092, supra note 53.

559 Advisers Act Rules 203A-3 and 206(3)-1.

The broker-dealer regulatory regime does not use the term investment advice and focuses instead on whether a broker-dealer has made a "recommendation."[560] Whether a recommendation has been made is a facts-and-circumstances determination to be made on a case-by-case basis that is not susceptible to a bright-line definition.[561] The content, context, and presentation of the particular communication or set of communications are all relevant factors.[562] Generally, communications that constitute a "call to action" or that "reasonably could influence" the customer to enter into a particular transaction or engage in a particular trading strategy are likely to be considered recommendations.[563] The more individually tailored the communication is to a particular customer or a targeted group of customers, the more likely it will be viewed as a recommendation. [564]

Examples—and not an exhaustive list—of communications that are generally viewed as constituting a recommendation include:

- Customer specific communications to a targeted customer or targeted group of customers encouraging the particular customer(s) to purchase a security or engage in a particular trading strategy;

- Communications stating that customers should be invested in stocks from a particular sector and urging customers to purchase one or more stocks from a list of "buy" recommendations;

- Portfolio analysis tools that generate a specific list of "buy" or "sell" recommendations for a customer based on information the customer has inputted regarding his investment goals and other personalized information;

- Technology that analyzes a customer's financial or online activity and sends specific investment suggestions that the customer buy or sell a security; [565] and

- Securities bought, sold, or exchanged in a discretionary account are considered implicitly recommended.[566]

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560 See, e.g., NASD Rule 2310; FINRA Rule 2111 (effective Oct. 7, 2011).

561 See NASD Notice to Members 01-23, "Suitability Rule and Online Communications."

562 Id.

563 See infra Section II.B.

564 See NASD Notice to Members 01-23, "Suitability Rule and Online Communications." See also Michael F. Siegel, 2007 NASD Discip. LEXIS 20 (NAC May 11, 2007) (finding that registered representative's communications with customers in which he, among other things, called specific securities a "good investment" and encouraged investors to consider investing in those securities and explained why they should do so in an influential manner amounted to a "call to action").

565 NASD Notice to Members 01-23, "Suitability Rule and Online Communications."

Examples of communications that generally would not constitute a "recommendation" under existing broker-dealer regulation (depending on the surrounding facts and circumstances), may include:

- General financial and investment information such as (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile.;[567]

- Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

- Asset allocation models that: (i) are based on generally accepted investment theory; (ii) be accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model; and (iii) comply with applicable FINRA interpretive material allowing investment analysis tools; [568] and

- Interactive investment materials that incorporate the above.[569]

Several commenters proposed definitions of "personalized investment advice," and also suggested exclusions from this definition. For example, SIFMA proposed the following definition of "personalized investment advice," which is largely consistent with the FINRA definition of "recommendation":

> investment recommendations that are provided to address the objectives or needs of a specific retail customer after taking into account the retail customer's specific circumstances.[570]

Other commenters suggested that "personalized investment advice" could include:

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566 See, e.g., Release 41816, supra note 289 at 20, n. 22; In the Matter of the Application of Paul C. Kettler, Exchange Act 31354 at 5, n.11 (Oct. 26, 1992).

567 See NASD IM-2210-6, "Requirements for the Use of Investment Analysis Tools."

569 See FINRA 2111.03 (effective Oct. 7, 2011). See also NASD Notice to Members 01-23, "Suitability Rule and Online Communications."

570 See SIFMA Letter, supra note 25.

- discretionary authority to make investment decisions in a customer's account, or an investment recommendation to a customer about one or more securities based on that customer's individual circumstances;[571] and

- activities that fall outside of the parameters set for "impersonal advisory services," as defined under Advisers Act Rule 203A-3.[572]

Commenters also provided a variety of suggestions regarding the products and services that should be excluded from the definition of "personalized investment advice" (and thereby exempt from any fiduciary standard), which the Commission could consider in developing the definition. The products and services that commenters recommended be excluded from the definition include: brokerage services (such as market making, underwriting, trade executions, and exercising limited time and price discretion);[573] ancillary account features or services (e.g., debit card, cash sweep, margin lending);[574] general advice and education (e.g., generalized securities research, investment tools and calculators, and target asset allocations);[575] discount brokerage accounts and on-line services;[576] limited purpose accounts that do not include personalized investment advice;[577] services provided by clearing firms to correspondent firms and their customers;[578] account and retail customer relationship maintenance (e.g., periodic contact to remind customer to rebalance assets to match allocations established at the time of contract purchase, absent efforts to recommend change the allocations percentages);[579]

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[571] See Schwab Letter, supra note 19.

[572] See, e.g., letter from Blaine F. Aikin, Chief Executive Officer, and Kristina A. Fausti, Director of Legal and Regulatory Affairs, fi360, dated Aug. 30, 2010 ("fi360 Letter").

[573] See, e.g., ABA & ABASA Letter, supra note 21; Ameriprise Letter, supra note 39; BOA Letter, supra note 17; Hartford Letter, supra note 471; Woodbury Letter, supra note 471.

[574] See, e.g., Ameriprise Letter, supra note 39; BOA Letter, supra note 17; SIFMA Letter, supra note 25.

[575] See, e.g., ABA & ABASA Letter, supra note 21; ACLI Letter, supra note 414; Ameriprise Letter, supra note 39; BOA Letter, supra note 17; Financial Planning Coalition Letter, supra note 471; Hartford Letter, supra note 471; ICI Letter, supra note 471; Schwab Letter, supra note 19; SIFMA Letter, supra note 25; Wells Fargo Letter, supra note 17; Woodbury Letter, supra note 471.

[576] See, e.g., BOA Letter, supra note 17; Wells Fargo Letter, supra note 17.

[577] See, e.g., Wells Fargo Letter, supra note 17.

[578] See, e.g., Wells Fargo Letter, supra note 17.

[579] See, e.g., ACLI Letter, supra note 414; CAI Letter, supra note 26.

needs analysis (e.g., meetings to determine customers' current and any new investment objectives and financial needs);[580] and unsolicited or customer-directed transactions.[581]

The phrases "personalized investment advice" and "recommendations" relate to existing terms of art in both the broker-dealer and investment adviser regimes. This usage suggests that the phrase "personalized investment advice about securities" in the uniform fiduciary standard could be read in a way that is consistent with the scope and interpretive history of both statutes. The Staff recommends that the Commission engage in rulemaking and/or issue interpretive guidance to define and/or interpret "personalized investment advice about securities" to provide clarity to broker-dealers, investment advisers, and retail investors. The Staff believes that such a definition *at a minimum* should encompass the making of a "recommendation," as developed under applicable broker-dealer regulation, and should not include "impersonal investment advice" as developed under the Advisers Act. Beyond that, the Staff believes that the term also could include any other actions or communications that would be considered investment advice about securities under the Advisers Act (such as comparisons of securities or asset allocation strategies), *except for* "impersonal investment advice" as developed under the Advisers Act.

Recommendation: The Commission should engage in rulemaking and/or issue interpretive guidance to explain what it means to provide "personalized investment advice about securities."

(a) Retail Customers

Dodd-Frank Act Section 913(g) amends the Advisers Act to add a definition of the term "retail customer."[582] Commenters raised some questions about applicability of the definition in certain specific scenarios. We recommend that the Commission engage in rulemaking or issue interpretive guidance on such points if it adopts and implements the uniform fiduciary standard. At that point, among other issues, the Staff recommends that the Commission specify that personalized investment advice provided to retail customers includes both advice to a specific retail customer on a one-on-one basis and to advice to a group of retail customers under circumstances in which members of the group reasonably would believe that the advice is intended for them.[583] The Commission could consider whether the uniform fiduciary standard should also be extended to persons other than retail customers that may also benefit from the additional investor protections that would be provided by the standard.[584]

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580 See, e.g., ACLI Letter, supra note 414. See also IAA Letter, supra note 462 (call centers providing factual information in response to customer inquiries).

581 See, e.g., BOA Letter, supra note 17; ICI Letter, supra note 471; Schwab Letter, supra note 19; SIFMA Letter, supra note 25; Wells Fargo Letter, supra note 17.

582 New Section 211(g)(2) defines "retail customer" as: "a natural person, or the legal representative of such natural person, who– (A) receives personalized investment advice about securities from a broker-dealer or investment adviser; and (B) uses such advice primarily for persona, family, or household purposes." The definition does not differentiate among investors on the basis of their wealth or investment experience.

4. Investor Education

As discussed above, many retail investors do not understand and are confused by the roles played by investment advisers and broker-dealers and the impact of the different regulatory regimes that apply to each. This lack of understanding is compounded by the fact that many retail investors may not have the time, information, market sophistication, or access needed to represent themselves effectively in today's complex capital markets when pursuing their financial goals.[585] Consistent with a number of commenters, the Staff believes that investor education can be helpful in addressing these concerns.[586]

To that end, the Commission should continue its ongoing program to improve the financial literacy of retail investors.[587] The Staff believes that these investor education

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583 See NASD Notice to Members 01-23, "Suitability Rule and Online Communications." The Staff also is concerned about communications with prospective customers. To the extent that prospective customers are not "retail customers," the Staff notes that the Commission's antifraud authority under both Advisers Act Sections 206(1) and (2) and Exchange Act Section 10(b) extends to fraudulent recommendations or other communications made to both existing and prospective clients and customers, thus providing significant protection against potential abuses in seminars and other marketing activities to prospective retail customers.

584 Exchange Act Section 15(k)(1) and Advisers Act Section 211(g)(1) authorize the Commission to extend the uniform fiduciary standard to "such other customers as the Commission may by rule provide…."

585 See *Financial Capability in the United States*, FINRA Investor Education Foundation, 2009 at 4. (http://www.finrafoundation.org/resources/research/p120478)

586 See, e.g., letter from Faith Bautista and Mia Martinez, Mabuhay Alliance dated Aug. 18, 2010 ("we urge that a Broker, Dealer and Investment Advisor Financial Literacy/Education Fund be established [for] community groups serving vulnerable communities"); Glenna R. Bohling, letter dated Aug. 31, 2010 ("[there is a] great need for financial education for the general population"); Susan Seltzer, The Derivatives Project, letter dated Dec. 30, 2010 ("Highlight the difference between a stockbroker and a SEC registered investment advisor on the SEC website and incorporate basics of cost-effective retirement investing today"). But see NAPFA Letter, supra note 489 ("While financial literacy programs are often touted as the "cure" for enabling consumers to make better financial decisions, a more reasoned review of the academic evidence suggests the ineffectiveness of financial literacy education"); CFA Letter, supra note 450 ("While not so extensive as to be conclusive, research also suggests that investors' lack of understanding cannot be dispelled through disclosures or investor education.").

587 See *SEC Strategic Plan for Fiscal years 2010- 2015*. Strategic Goal 3. The Commission's Office of Investor Education and Advocacy ("OIEA") has a robust outreach and education program that uses a multi-pronged approach to reach retail investors. That approach includes: targeting specific populations such as seniors, young investors, the military, teachers, and affinity groups; working through national financial literacy coalitions and grassroots organizations; and creating plain English publications disseminated widely both online and in hard copy. OIEA also publishes regularly investor alerts and bulletins to keep retail investors informed about current issues or actions that may affect them. In 2010, these educational programs reached over 25 thousand individual investors in person through presentations and conference exhibits. In addition, OIEA distributed approximately 330,000 publications and reached 10 million taxpayers through an IRS

programs could be enhanced in a number of ways to help investors better understand the uniform fiduciary standard and to make better-informed decisions when selecting a financial professional. First, the staff could, where needed, design improved curriculum materials to assist retail investors, sponsor investor education workshops, and work in partnership with non-profit and community organizations to implement financial literacy programs designed to, among other things, help investors understand the uniform fiduciary standard and its application to personalized financial advice about securities. To design the most effective messaging and educational tools, public opinion research could be used to further understand how and why investors choose financial professionals, and the best way to interest investors or potential investors in gaining the information they need to make informed decisions.

To be most effective, the increased educational initiatives would need the scale and scope to reach large numbers of investors and future investors. Such programming has the potential to use substantial Commission resources and time; therefore, it likely would require additional Commission resources to implement effectively.

Recommendation: The Commission should consider additional investor education outreach as an important complement to the uniform fiduciary standard.

D. Harmonization of Regulation

The recommendations outlined above provide several potential areas for harmonization of the regulation of investment advisers and broker-dealers, particularly as they relate to standards of care and conduct when providing personalized investment advice about securities to retail customers. Outlined below are other areas in which investment adviser and broker-dealer regulations differ, and the Staff recommends that the Commission consider whether the regulations that apply to those functions should be harmonized. The Commission could consider these issues as part of the implementation of the uniform fiduciary standard or as separate initiatives. In addition, Dodd-Frank Act Section 913(h)(2) provides that the Commission shall "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

In addition to considering the adoption of the uniform fiduciary standard, the Staff recommends that, when broker-dealers and investment advisers are performing the same or substantially similar functions, the regulatory protections should be the same or substantially similar; that is, that harmonization should be considered to the extent that such harmonization appears likely to add meaningful investor protection.

The Staff believes that all investors deserve the same protections regardless of where they choose to obtain investment advice. Currently, investors have different levels

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mailing. Currently, OIEA is relaunching its retail investor oriented web site, www.Investor.gov, to be a centralized source of unbiased and understandable investment information.

of protection depending on the registration status (i.e., investment adviser or broker-dealer) and whether the investor has a brokerage or an advisory account. Under the present system, investors not only must consider what investments to make, but also the level of protection that they want to enjoy (assuming the investor understands the different levels of protection). Investors may even face these decisions when seeking the same advice from the same institution and the same professional, depending on whether they have a brokerage or advisory relationship. This creates unnecessary risk and complexity for investors by placing the burden on them to understand regulatory differences and to make rational economic decisions in the face of those differences. To this end, such harmonization should take into account the best elements of each regime. The Staff believes that where investment advisers and broker-dealers perform the same or substantially similar functions, they should be subject to the same or substantially similar regulation.

Commenters have noted a number of differences in current investment adviser and broker-dealer regulation that could be harmonized to improve retail investor protection. The following is not intended to be a comprehensive or exclusive listing of potential areas of harmonization; there may be other requirements, not addressed below, that the Commission also might wish to harmonize. The potential areas of harmonization are listed below generally in the order in which they implicate broker-dealer and investment adviser activity with retail investors. In making recommendations, the Staff focused on the elements of each regulatory regime that it believes are most effective in protecting retail investors.

In addition as discussed above, although broker-dealers and Commission-registered investment advisers are subject to different financial responsibility requirements, the Staff is not making a recommendation at this time on this subject.

1. Advertising and the Use of Finders and Solicitors

a) Advertising and Other Communications

The regulation of advertising is particularly important because of the impact it has on retail investors. In particular, the RAND Study noted that the rise of "do it all" advertisements helped contribute to investor confusion about the roles and duties of investment advisers and broker-dealers.[588] Advertising, by which the Staff refers to print, radio, and television advertisements as well as communications with prospective retail customers (such as mailings, seminars, and presentations to investors), is subject to different regulation under the Advisers Act and the Exchange Act and FINRA rules. Some commenters believe that these differences in regulation may constitute a gap in regulation.[589]

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588 RAND Report, supra note 454 at xix.

589 See, e.g., FINRA Letter, supra note 471; FSI Letter, supra note 471; LPL Letter, supra note 471; and UBS Letter, supra note 39; PIABA, SEC IA-BD Study Group Meeting Notebook, Nov. 30, 2010.

One of the most significant differences between investment adviser and broker-dealer regulation is that, under certain circumstances, a registered principal of the broker-dealer must approve a communication before distributing it to the public, and certain communications must be filed with FINRA for approval.[590] There are no similar pre-use review and regulatory approval requirements for investment adviser communications.[591]

Both investment advisers and broker-dealers are subject to general prohibitions of misleading or otherwise inappropriate communications[592] and to specific content restrictions. While the general prohibitions are broadly similar, the specific content restrictions differ. For example, investment advisers are prohibited in advertisements from using testimonials and restricted in using past specific recommendations.[593] While broker-dealers are not subject to prohibitions on testimonials, they are subject to other restrictions relating to testimonials and using past recommendations.[594] In addition, under the general antifraud provisions of the Advisers Act, extensive guidance has developed about the circumstances under which adviser investment performance information would or would not be considered misleading.[595] The body of interpretive or other guidance on broker-dealer use of performance is less detailed and extensive, reflecting the fact that in practice broker-dealers present performance data much less

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590 See NASD Rule 2010(c)(4). FINRA must preapprove certain communications relating to registered investment companies, collateralized mortgage obligations, security futures, or bond mutual funds including bond mutual fund volatility ratings. Id. In addition, broker-dealers generally must file with FINRA within 10 days of first use or publication certain communications with the public regarding registered investment companies, direct participation programs, and government securities, and templates concerning an investment analysis tool, among others). See NASD Rule 2210(c)(2).

591 As discussed in Section II.B above, the Commission has brought enforcement actions against advisers for false or misleading advertising.

592 See, e.g., Exchange Act Sections 10(b) and 15(c) and Rule 10b-5 thereunder, and Advisers Act Section 206(4) for the general prohibitions.

593 See Advisers Act Rule 206(4)-1.

594 FINRA rules require that if any testimonial in a communication with the public concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion. See FINRA Rule 2210(d)(1)(E). Furthermore, FINRA rules mandate that advertisements or sales literature providing any testimonial concerning the investment advice or investment performance of a member or its products include prominent disclosure of certain information relating to the testimonial. FINRA Rule 2210(d)(2). FINRA also restricts a member's ability use material referring to past recommendations. See IM-2210-1(6)(C).

595 For example, broker-dealers are subject to specific rules and guidance relating to performance information (e.g., prohibitions against hypothetical or back-tested performance presentations in communications with the public). See NASD Rules 2210 and 2211. See also FINRA Interpretative Letter (Oct. 2, 2003).

often. Broker-dealers are subject to other specific rules regarding the content of communications with the public.[596]

The Staff believes that, with the significant impact that advertising and other firm communications have on retail investors, at a minimum, it could be beneficial for investment advisers to designate employees (such as members of the firm's compliance department) to review and approve communications before they are distributed to the public.[597]

Any harmonization of advertising requirements would need to be done by an SRO (with respect to broker-dealer requirements) or the Commission, either through rulemaking or guidance.

Recommendation: The Commission should consider articulating consistent substantive advertising and customer communication rules and/or guidance for broker-dealers and investment advisers regarding the content of advertisements and other customer communications for similar services. In addition, the Commission should consider, at a minimum, harmonizing internal pre-use review requirements for investment adviser and broker-dealer advertisements or requiring investment advisers to designate employees to review and approve advertisements.

a) Use of Finders and Solicitors

A retail investor may retain the services of an investment adviser or broker-dealer based on information from a solicitor or finder who is paid by the investment adviser or broker-dealer.[598] The regulation of solicitors differs for investment advisers and broker-dealers. Receipt of transaction-based compensation in exchange for effecting transactions in securities (including soliciting investors) generally requires registration as a broker-dealer.[599] Under Advisers Act regulations, a solicitor is not required to register as an investment adviser unless it otherwise meets the definition of investment adviser. The Advisers Act regulation focuses instead on disclosure to clients of material conflicts: an investment adviser and a solicitor must enter into a written agreement (including the nature of the relationship between the investment adviser and the solicitor and the terms of any compensation agreement) requiring the solicitor to provide certain up-front

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596 See FINRA Rule 2210.

597 Many investment advisers may currently require review and approval of advertisements pursuant to compliance policies and procedures that are required by Advisers Act Rule 206(4)-7. The Staff also has recommended that the Commission consider whether to extend to investment advisers a more detailed supervisory regime with a focus on the supervisory oversight of retail client services. See Section IV.D.3, infra.

598 This discussion will use the word solicitor to refer to both solicitors used by investment advisers and finders used by broker-dealers.

599 See also infra Section II.B.

disclosure to prospective clients.[600] In addition, the adviser also has an obligation to supervise the solicitation activities of solicitors, and the adviser must treat the solicitor as an associated person to the extent the solicitor acts as such for the adviser.[601] The Commission received a limited number of comments on this issue in connection with the Study. The Staff believes that the Commission should consider reviewing the use of solicitors by investment advisers and broker-dealers to determine whether guidance or amendments to existing rules are appropriate, including whether to harmonize the approach to regulating solicitors.

Recommendation: The Commission should review the use of finders and solicitors by investment advisers and broker-dealers and consider whether to provide additional guidance or harmonize existing regulatory requirements to address the status of finders and solicitors and disclosure requirements to assure that retail customers better understand the conflicts associated with the solicitor's and finder's receipt of compensation for sending a retail customer to an adviser or broker-dealer.

2. Remedies

There are certain key differences in the rights of customers against broker-dealers and clients against investment advisers. Notably, broker-dealer customers typically are required by contract with their broker-dealers to arbitrate any eligible dispute against a broker-dealer and its associated persons upon demand through the FINRA arbitration forum;[602] and FINRA rules require broker-dealers to arbitrate with their customers (whether or not there is a pre-dispute arbitration clause) and prescribe the content and format of pre-dispute arbitration clauses in customer agreements. By contrast, advisory clients may elect to have disputes arbitrated either through a pre-dispute or post-dispute agreement regarding a resolution forum, but there are no regulatory requirements for the content and format of arbitration clauses in advisory agreements (although in practice, advisers whose agreements include such clauses generally follow the FINRA model) and the procedures and fees that will be applied to such forum.[603] Broker-dealer customers have private rights of action for damages under certain provisions of the Exchange Act. By contrast, advisory clients have a very limited private right of action under the Advisers Act that enables clients to seek to void an investment adviser's contract and obtain restitution of fees paid.[604] Both broker-dealer customers and advisory clients have private rights of action for damages under Exchange Act Section 10(b) and Rule 10b-5 or applicable state law.

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600 See Advisers Act Rule 206(4)-3.

601 See Advisers Act Rule 206(4)-3; Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1633 (May 15, 1997).

602 See Rule 12200 of the FINRA Code of Arbitration Procedure for Customer Disputes.

603 See, e.g., the American Arbitration Association and JAMS.

604 See Transamerica, supra note 82.

Several commenters noted that the lack of a specialized arbitration forum for all investors may constitute a gap in regulation.[605] Such commenters stated that a specialized arbitration forum has a number of benefits for investors, including: (1) the ability to make decisions based on equity that are not necessarily required by law;[606] (2) it is generally less costly and more cost effective, efficient, and accessible (relaxed rules of evidence and fewer barriers to entry) than litigation;[607] (3) it is tailored to the industry staffed with individuals that are knowledgeable about the industry, its products and best practices.[608]

Nevertheless, during the Dodd-Frank Act legislative process, concerns were raised regarding mandatory-pre-dispute arbitration, including costs and limited grounds for appeal, among others.[609] Dodd-Frank Act Section 921 amends the Exchange Act and the Advisers Act to provide the Commission with the authority to promulgate rules that prohibit or impose conditions or limitations on the use of agreements that require customers to arbitrate disputes, if it finds that such prohibition, imposition of conditions, or limitations, would be in the public interest and for the protection of investors.

Broker-dealers generally are required to by FINRA rules to pay monetary awards within 30 days of receipt.[610] FINRA may suspend or cancel the membership of any member, or suspend any associated or formerly associated person from association with any member, for failure to comply with an arbitration award or with a written and executed settlement agreement obtained in connection with an arbitration or mediation.[611] Investment advisers are not subject to such sanctions, and legislation might be required for the Commission to impose them.

While the Staff notes the differences between the arbitration practices for investment advisers and broker-dealers and the concerns raised by commenters, it does

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605 See, e.g., Black Letter, supra note 483; FSI Letter, supra note 471; Woodbury Letter, supra note 471.

606 See, e.g.,, Black Letter, supra note 483; FSI Letter, supra note 471.

607 See, e.g., FSI Letter supra note 471; Woodbury Letter, supra note 471.

608 See, e.g., Woodbury Letter, supra note 471.

609 Report of the Senate Committee on Banking, Housing, and Urban Affairs on S. 3217, S.Rep. No. 111-176, at 110 ("There have been concerns over the past several years that mandatory pre-dispute arbitration is unfair to the investors.").

610 See FINRA Rule 12904(j).

611 See NASD By-Laws, Art. VI, Sec. 3(b); NASD By-Laws, Art. V., Sec. 4(b); NASD Notice to Members 04-57, "NASD Extends Jurisdiction to Suspend Formerly Associated Persons Who Fail to Pay Arbitration Awards" (Aug. 2004). From 2005 to 2009, FINRA has annually suspended up to 5 firms and between 321 and 363 individuals; during the same years, it has annually expelled 15 to 20 firms and barred 263 to 282 individuals. See http://www.finra.org/Newsroom/Statistics/

not recommend that the Commission take any action relating to arbitration as part of these recommendations, because Section 921 provides the Commission the opportunity to review this issue in greater detail.

3. Supervision

While both broker-dealers and investment advisers are required to supervise persons that act on their behalf, broker-dealers generally are subject to more specific supervisory requirements. Because abusive sales practices can stem from and persist under ineffective supervisory systems and control procedures, ensuring the adequacy of supervisory systems is an important tool in protecting investors as well as the integrity of the securities markets. In particular, the Exchange Act requires broker-dealers to supervise their associated persons.[612] Further, SRO rules explicitly require broker-dealers to, among other things: (1) establish a supervisory system that includes the designation of a supervisory hierarchy, including the assignment of a direct supervisor for each registered representative;[613] (2) conduct periodic inspections of its supervisory branch offices, non-supervisory branch offices, and unregistered locations;[614] and (3) supervise the outside business activities and private securities transactions of associated persons.[615]

In contrast, the personal securities trading provisions of the Advisers Act code of ethics rule (Advisers Act Rule 204A-1) are more extensive in certain respects than the requirement that broker-dealers supervise private securities transactions. Otherwise, the requirements for advisers are mostly more general and implicit: advisers and their officers are liable if they fail to supervise associated persons; and the Staff's interpretations of the Advisers Act compliance rule embody an expectation that an adviser's compliance processes will include provisions for effective supervision.

Although some industry commenters, as well as FINRA, suggested that the Commission address the difference in supervisory structure by harmonizing the supervision requirements applicable to investment advisers and broker-dealers, the Commission received a limited number of comments on this topic in connection with the Study.[616] The Staff believes that the Commission should consider reviewing supervisory requirements. In reviewing these requirements, the Commission could consider whether a single set of universally applicable requirements would be appropriate. Alternatively, the Commission could consider whether supervisory structure requirements should be scaled based on the size (e.g., number of employees) and nature of a broker-dealer or an investment adviser.

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612 See Exchange Act Section 15(b)(4)(E).

613 See FINRA Rule 3010.

614 See FINRA Rule 3010(c).

615 See FINRA Rules 3270 and 3040. See Section II.B, infra, for a more detailed discussion of supervisory requirements applicable to investment advisers and broker-dealers.

616 See, e.g., AALU Letter, supra note 472; CAI Letter, supra note 26; FINRA Letter, supra note 471.

Recommendation: The Commission should review supervisory requirements for investment advisers and broker-dealers, with a focus on whether any harmonization would facilitate the examination and oversight of these entities (e.g., whether detailed supervisory structures would not be appropriate for a firm with a small number of employees), and consider whether to provide any additional guidance or engage in rulemaking.

4. Licensing and Registration of Firms

Investment advisers register on Form ADV Part 1, and broker-dealers register on Form BD. The two forms are similar in many respects, and Form ADV originally was modeled on Form BD. Commenters have suggested that the registration processes should be unified and streamlined by requiring both investment advisers and broker-dealers to register on a unified form.[617]

Developing a uniform registration form in theory could reduce some regulatory burdens by allowing dual registrants to use a single form to register both as broker-dealers and investment advisers. However, about 611 firms are dually registered with the Commission, and most of those that are dual registrants are very large firms in terms of assets and number of employees.[618] Accordingly, only a relatively small number of firms would benefit from the reduced regulatory burdens, and the requirement to complete a new, unified form could increase firms' regulatory burdens, at least on a one-time basis. Finally, a uniform registration form, while potentially simplifying the process for dual registrants (although firms would likely incur costs as they transition to a new form), likely would not enhance investor protection or ameliorate investor confusion and likely would create some level of confusion and increase the burden of compliance for all firms that are not dual registrants. The Staff recommends that, where Form ADV and Form BD ask for the same (or very similar) information, the Forms' requirements should be made as uniform as feasible.[619] This would enable comparison by regulators and investors.

In addition to completing Form BD, broker-dealers must satisfy the membership requirements of FINRA (or another SRO) before commencing business. FINRA's process for evaluating membership applications aims to fully evaluate relevant aspects of applicants and to identify potential weaknesses in their internal systems, thereby helping to ensure that successful applicants would be capable of conducting their business in

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617 See, e.g., LPL Letter, supra note 471.

618 See Section II.A, supra, for data on dual registrants.

619 See also infra Section IV.C.1.a, discussing the Staff's recommendation that the Commission consider rulemaking to develop a uniform approach to disclosure that would provide retail customers of both broker-dealers and investment advisers with relevant key pieces of information at the outset of the advisory or brokerage relationship and at appropriate times thereafter, which would presumably include extending to broker-dealers a requirement of a general relationship disclosure document analogous to Form ADV Part 2.

compliance with applicable regulation.[620] The FINRA membership process includes: a membership application (including among other things, a business plan and a description of: the nature and source of capital with supporting documentation; the financial controls to be employed; the supervisory system and copies of certain procedures); a membership interview; compliance with applicable state licensing; establishment of a supervisory system; and a membership agreement. In evaluating a membership application, FINRA will consider, as a whole, the applicant's business plan, information and documents submitted by the applicant, information provided during the membership interview, and other information obtained by the Staff, taking into account a variety of standards, including whether (1) the applicant and its associated persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade and (2) whether the applicant has the operational and financial capacity to comply with the federal securities laws, the rules and regulations thereunder, and FINRA rules.[621] Investment advisers are not subject to this type of review by the Commission, but certain states informed the Staff that they perform a more qualitative review of investment advisers prior to granting them registration.

The Commission could consider whether to engage in a more substantive review of an investment adviser's application. The Staff believes that a more substantive review of investment adviser applications for registration could improve investor protection as it could help prevent firms that are unprepared to meet the obligations they will be assuming under the federal securities laws from entering the advisory business. However, without additional resources, the Staff believes that it would not be feasible at this time for the Commission to engage in a more substantive review of investment adviser applications.

Recommendation: The Commission should consider whether the disclosure requirements in Form ADV and Form BD should be harmonized where they address similar issues, so that regulators and retail customers have access to comparable information. The Commission also should consider whether investment advisers should be subject to a substantive review prior to registration.

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620 See FINRA Regulatory Notice 10-01, "Membership Application Proceedings: Proposed Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings (Jan. 2010) ("[FINRA's Membership Application Process ("MAP")] is a fluid, probing exercise that seeks to evaluate all relevant facts and circumstances regarding each applicant. In particular, the MAP seeks to identify potential weaknesses in an applicant's supervisory, operational and financial controls. The MAP's ultimate goal is to ensure that each applicant is capable of conducting its business in compliance with applicable rules and regulations, and that its business practices are consistent with just and equitable principles of trade as required by FINRA rules.").

621 See NASD Rule 1014(a). For a more detailed discussion of FINRA's application review process see Section II.B.

5. Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers

Associated persons of broker-dealers generally are required to be registered with FINRA (other than persons whose functions are solely clerical or ministerial) and must disclose their employment and disciplinary histories and keep that information current.[622] Associated persons who effect securities transactions also must meet qualification requirements, which include passing a securities qualification exam, and must fulfill continuing education requirements.[623] Some commenters have stated that these requirements help to ensure that financial professionals are subject to minimum and ongoing competency requirements, and thus create a useful barrier to entering and remaining in the profession.

There is no federal or SRO licensing requirement for investment adviser personnel. However, investment adviser representatives who are required to be licensed by the states generally must pass certain securities exams or hold certain designations (such as a Certified Financial Analyst).

Some commenters have pointed out the lack of federal or SRO requirements for personnel of Commission-registered investment advisers regarding licensing, registration, and continuing education as a gap in current investment adviser regulation that should be addressed under the Advisers Act.[624]

The lack of a continuing education requirement and uniform federal licensing requirement for investment adviser representatives may be a gap,[625] but establishing such requirements for investment adviser representatives may raise certain challenges for the Commission, given the current lack of infrastructure and resources to administer an education and testing program. The Staff notes, however, if these requirements were imposed, a private organization could develop the program.

Recommendation: The Staff recommends that the Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.

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622 See generally NASD Rule 1000 Series.

623 See NASD Rule 1120.

624 See, e.g., AALU Letter, supra note 472; BOA Letter, supra note 17; FSI Letter, supra note 471; Hartford Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39; Woodbury Letter, supra note 471. Investment adviser personnel of Commission-registered investment advisers may be subject to state licensing requirements, as discussed more fully in Section II.C,1 supra.

625 Id.

7. Books and Records

Differences also exist in the books and records requirements applicable to broker-dealers and investment advisers. While many differences reflect distinctions in their overall business activities, others do not. More generally, the rules for broker-dealers require the retention of all communications received and sent, as well as all written agreements (or copies thereof), relating to a firm's "business as such,"[626] whereas the rules for advisers require only the retention of materials falling in specific enumerated categories, meaning that many important records relating to an adviser's business may not be available for internal supervision and compliance oversight or for inspection by Commission staff. These differences limit the effectiveness of internal supervision and compliance structures and the ability of regulators to access information and verify the entity's compliance with applicable requirements. This could have the effect of diminishing the level of investor protection that results from regulatory examination programs. A number of brokerage industry commenters also suggested that the recordkeeping requirements be harmonized to require broker-dealers and investment advisers to maintain similar records for the same time periods.[627]

Recommendation: The Commission should consider whether to modify the Advisers Act books and records requirements, including considering a general requirement to retain all communications and agreements (including electronic communications and agreements) related to an adviser's "business as such," consistent with the standard applicable to broker-dealers.

E. Alternatives to the Uniform Fiduciary Standard

1. Repealing the Broker-Dealer Exclusion

A broker-dealer is currently excluded from the definition of "investment adviser" under the Advisers Act if it provides investment advice that is "solely incidental to the conduct of his business as a broker or dealer" and "receives no special compensation therefor" (the "broker-dealer exclusion").[628] If the broker-dealer exclusion were repealed, any broker-dealer that provided investment advice would need to consider whether it had to register as an investment adviser with a state or the Commission.

Repealing the broker-dealer exclusion could have certain benefits. For example, financial services could be divided into two categories: a) investment advice (regulated under the Advisers Act), and b) brokerage activities (e.g., execution and dealer activities) (regulated under the Exchange Act).[629] It could help reduce investor confusion about the

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626 See Exchange Act Rule 17a-4(b)(4) and (b)(7).

627 See, e.g., FSI Letter, supra note 471; LPL Letter, supra note 471.

628 Advisers Act Section 202(a)(11)(C).

629 One industry commenter claimed that removing the broker-dealer exclusion would "completely" eliminate any differences or gaps in the standard of conduct applicable to broker-dealers and investment advisers when providing personalized investment advice or recommendations. However,

different regulatory regimes that apply to broker-dealers and investment advisers, and it might superficially simplify the Commission's task in regulating these two types of securities professionals.[630] However, the Staff believes that any benefits of eliminating the broker-dealer exclusion would not be justified by the potential negative outcomes, as discussed in more detail below.

2. Imposition of the Standard of Conduct and Other Requirements of the Advisers Act

Dodd-Frank Act Section 913(c)(9) also requires the Study to consider the potential impact of imposing on broker-dealers the standard of care applied under the Advisers Act for providing personalized investment advice about securities, and other requirements of the Advisers Act.[631] Like the elimination of the broker-dealer exclusion, this approach might simplify the Commission's regulation of investment advice by uniformly imposing the Advisers Act requirements on broker-dealers (rather than developing a more tailored approach). In addition, it would avoid imposing any additional investment adviser registration costs on broker-dealers. Nevertheless, as with the broker-dealer exclusion, the Staff believes that any potential benefits of this option would not be justified by the potential drawbacks, as discussed below.

3. Potential Drawbacks of Both Approaches

Unlike the uniform fiduciary standard, both of these approaches could result in the imposition of the entire investment adviser regulatory regime on a broker-dealer, without considering whether it would be disruptive (in the case of the broker-dealer exclusion) and/or duplicative (in the case of both the broker-dealer exclusion and the application of Advisers Act regulation on the broker-dealer). If a broker-dealer were required to register as an investment adviser with a state, rather than the Commission, the broker-dealer could find itself subject to federal regulation with respect to its brokerage activities, and state (and possibly also federal) regulation with respect to its advisory activities.

The Staff believes that the additional potential drawbacks to both of these approaches include the following, as discussed below: (1) they could prevent the

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the commenter ultimately rejected the broker-dealer exclusion as a viable option, as discussed below. See, e.g., IAA Letter, supra note 462. See also PIABA Letter, supra note 482.

630 However, if broker-dealers were required to register with the Commission under the Advisers Act, the Commission would be tasked with examining these new registrants. Absent additional funding or an investment adviser SRO, this might create a significant burden on the Commission, because the SROs typically perform inspections of broker-dealers.

631 There is some ambiguity as to which Advisers Act standards Congress intended to be applied to broker-dealers pursuant to this alternative. At its most expansive, the effect of this option could result in the application of the entire Advisers Act to broker-dealers and registered representatives that provide investment advice, with the exclusion of the Advisers Act's registration requirements. At its most narrow, this option would impose fiduciary duty upon broker-dealers. For purposes of this analysis, the Staff interprets it in its broadest sense.

Commission from evaluating the existing regulatory regimes and applying the best elements of each to advisers and broker-dealers; (2) they might result in fewer investor choices; and (3) they would likely be more costly for investors and the industry, as discussed in Section V below. Generally, these drawbacks would result from, among other things, the fact that both approaches could involve the wholesale application of the requirements of the Advisers Act to broker-dealers, without limiting such application solely to the provision of investment advice.

Several commenters (including investor advocates and industry commenters) did not support either option. Specifically, an investor advocate noted that "[n]o one that we are aware of is seriously contemplating advocating this approach [of eliminating the broker-dealer exclusion]…if investors are to receive the benefits of a fiduciary duty for brokers, it is up to the Commission to provide it through its rulemaking process."[632] Similarly, an investment adviser industry commenter noted that while it originally supported such a change, it believed that the Commission could achieve a similar result by imposing by rule a fiduciary duty that requires broker-dealers to act in the best interests of their clients when providing personalized investment advice.[633]

a) Inability to Take the Best from Each Regulatory Regime

Repealing the broker-dealer exclusion or imposing the requirements of the Advisers Act on broker-dealers may not allow the Commission to take the best of each regulatory regime and apply it to broker-dealers and investment advisers performing the same functions. The Staff believes, therefore, that the uniform fiduciary standard would be a more thoughtful, flexible and practical approach in uniformly regulating investment advisers and broker-dealers that provide the same services.

A number of commenters made arguments that reinforced the benefits of a thoughtful approach to the harmonization of regulation governing personalized investment advice and recommendations about securities to retail customers. For example, commenters argued that neither of these approaches – repealing the broker-dealer exclusion or imposing the Advisers Act standard of conduct and other requirements on broker-dealers - would achieve the harmonization of standards relating to the provision of investment advice to retail customers that they think the Dodd-Frank Act intended.[634] Notably, many commenters stated that there are benefits to the current regulation of investment advisers

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632 See, e.g., CFA Letter, supra note 450 (further noting that "given the limited timeframe under which the Commission is operating, we believe that time would best be spent analyzing issues that are directly relevant to actions the Commission is likely to take. We therefore recommend that the Commission spend the minimum time and effort necessary to satisfy this aspect of the study.").

633 See, e.g., IAA Letter, supra note 462.

634 See, e.g., Pacific Life Letter, supra note 471 ("Simply eliminating the broker-dealer [exclusion] from the definition of "investment adviser" under section 202(a)(11)(C) of the Investment Advisers Act of 1940 would not achieve the harmonization of standards sought by the Dodd-Frank Act.").

and broker-dealers that should be maintained and extended to the provision of investment advice or recommendations about securities by both investment advisers and broker-dealers.[635]

Broker-dealer commenters point out that another failure of the wholesale application of Advisers Act, as opposed to harmonization of broker-dealer and investment adviser regulation, is that the Advisers Act requirements would apply not only to a broker-dealer's provision of personalized investment advice, but would also extend to other brokerage activity that does not involve the provision of such advice and that may already be subject to extensive regulation under the Exchange Act.[636]

In addition, brokerage industry commenters also argued that either of these options would subject broker-dealers that are not dually-registered currently to duplicative regulation, that would not enhance investor protection and would only increase firms' costs.[637] Specifically, commenters point to the following areas where duplication would arise: registration and licensing;[638] disclosures;[639] books and records requirements;[640] and policies and procedures requirements.[641] Brokerage industry commenters were also very concerned about the potential negative consequences of applying the principal trading

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635 See, e.g., BOA Letter, supra note 17 (citing to a number of regulatory protections that attach to a brokerage relationship, but not present in an advisory relationship, including licensing and continuing education requirements for registered representatives; fidelity bond requirements, and frequent examination); IAA Letter, supra note 462 (acknowledging that "[s]ome in the broker-dealer community have argued that certain broker-dealer requirements are more protective of retail investors and should be applied to investment advisers" and that the IAA is "open to constructive dialogue with the Commission to enhance investment adviser regulation where appropriate."); LPL Letter, supra note 471 (noting that, on one hand, the required disclosure of conflicts of interest and the delivery of a brochure to potential clients describing services, investment skills, regulatory record, pricing for services and conflicts of interest is a strength of the investment adviser regime that may be extended to broker-dealers, and that the existence of detailed supervisory requirements and suitability guidelines, and examination by an SRO are vital to the brokerage regulatory regime); UBS Letter, supra note 39 ("[T]he current debate largely ignores the disparity in regulation of broker-dealers and investment advisers, and focuses on the one difference that advisers have chosen to highlight – the existence of a fiduciary duty. . . .The Commission's efforts at harmonization should also focus on current gaps in the regulation of investment advisers.").

636 See, e.g., Schwab Letter, supra note 19; SIFMA Letter, supra note 25.

637 See, e.g., NAIFA Letter, supra note 552.

638 See, e.g., NAIFA Letter, supra note 552; TC Services Letter, supra note 493. The Staff notes that the duplicative registration and licensing requirements would only occur with respect to the elimination of broker-dealer exclusion, and would not necessarily result from the imposition of the Advisers Act standard of conduct or other requirements of the Advisers Act.

639 See, e.g., NAIFA Letter, supra note 552.

640 See, e.g., TC Services Letter, supra note 493.

641 See, e.g., TC Services Letter, supra note 493.

restrictions in Advisers Act Section 206(3) to their activities. The potential consequences are discussed in the Cost Analysis in Section V.

Accordingly, the Staff believes the uniform fiduciary standard would provide investor protection, while also providing the flexibility in how to address the implementation issues, including those associated with principal trading for broker-dealers and investment advisers. In addition, the Staff has recommended that the Commission pursue increased harmonization of the broker-dealer and investment adviser regulatory regimes, with the focus on the elements that are most effective in regulating the relationship between broker-dealers or investment advisers and their retail customers and clients.

b) Loss of Investor Choice

The Staff also is concerned that eliminating the broker-dealer exclusion or imposing the requirements of the Advisers Act would have a more adverse impact on retail investor choice of products and services, and how investors pay for those products and services, than adopting the uniform fiduciary standard. These potential consequences are discussed in the Cost Analysis below.

V. Cost Analysis

A. Introduction

The Staff is sensitive to the costs that could be incurred by investors, broker-dealers, investment advisers, and their associated persons due to any change in legal or regulatory standards related to providing personalized investment advice to retail investors. Section 913 requires this Study to consider a number of potential costs, expenses and impacts of various regulatory changes. In particular, Section 913(c)(13) requires this Study to consider the potential additional costs and expenses to: (a) retail customers regarding, and the potential impact on the profitability of, their investment decisions; and (b) brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, investment advisers, and their associated persons relating to their obligations, including duty of care, to retail customers. Relatedly, Section 913(c)(9) requires the Study to consider the potential impact on retail customers, including the potential impact on their access to the range of products and services offered by broker-dealers, of imposing on broker-dealers the standard of conduct applied under the Advisers Act for providing personalized investment advice about securities to retail customers of investment advisers, and other requirements of the Advisers Act. Section 913(c)(10) requires consideration of any additional costs to brokers, dealers and associated persons that could result from the elimination of the broker-dealer exclusion.

As discussed above, the primary recommendation of the Study is that the Commission should consider proposing rules that would require broker-dealers and investment advisers to operate under a uniform fiduciary standard of conduct when

providing personalized investment advice about securities to retail investors. The Staff also recommends that the Commission consider whether certain regulatory requirements should be harmonized in conjunction with implementing the uniform fiduciary standard of conduct. As discussed above, the Staff does not recommend eliminating the broker-dealer exclusion.

Certain recommendations would require rulemaking by the Commission. The rulemaking process would provide the opportunity for the Commission to request comment on potential costs and benefits associated with the rulemaking, and would assist the Commission's goals (and the goals of Section 913) to preserve retail investor choice, as part of the Commission's mandate to protect investors with respect to, among other things, availability of accounts, products, services, and relationships with investment advisers and broker-dealers,[642] and not inadvertently eliminate or otherwise impede (for example, through higher costs that investors are unwilling to bear) retail investor access to such accounts, products, services and relationships.

The costs associated with possible regulatory outcomes are difficult to quantify.[643] Data relating to costs as well as profitability of investments were not provided by commenters. For example, data comparing the costs and profitability to retail customers of broker-dealers and investment advisers, for comparable products and services, provided by commenters. Data comparing the profitability to broker-dealers and investment advisers when providing comparable products and services, which would have been helpful in analyzing the costs on broker-dealers and investment advisers, also were not provided by commenters. Although these data would have been instructive to the Staff, the data would not necessarily have been determinative because the recommendation to adopt a uniform fiduciary standard is intended to address the integrity of personalized investment advice to retail investors and is based on a desire to promote full, fair and clear disclosure of relevant conflicts.

Generally, commenters did not quantify particular costs or even give a range of costs that they would incur for the various potential outcomes. While some commenters

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642 See, e.g., ABA & ABASA Letter, supra note 21; ACLI Letter, supra note 414; AXA Letter, supra note 503; BOA Letter, supra note 17; letter from Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable, dated Aug. 30, 2010 ("Financial Services Roundtable Letter"); FSI Letter, supra note 471; Hartford Letter, supra note 471; ICI Letter, supra note 471; Janney Letter, supra note 30; Lincoln Letter, supra note 504; NSCP Letter, supra note 503; SIFMA Letter, supra note 25; UBS Letter, supra note 39; Wells Fargo Letter, supra note 17; Woodbury Letter, supra note 471.

643 In general, however, imposition of a new standard of conduct on broker-dealers has a potential for additional costs on broker-dealers. In addition, the harmonization recommendations have the potential to increase costs on advisers. See Oliver Wyman, Securities Industry and Financial Markets Association, Standard of Care Harmonization: Impact Assessment for SEC, dated Oct. 2010 ("OW/SIFMA Study"). See also Deloitte LLP, Firm Behaviour and Incremental Compliance Costs: Research for the Financial Services Authority, dated May 14, 2009, and Oxera, Retail Distribution Review Proposals: Impact on Market Structure and Competition, Prepared for the Financial Services Authority, dated Mar. 2010 (together, "FSA Reports").

that addressed the impact of regulatory changes predicted that certain outcomes could occur, the commenters did not forecast what any particular regulated entity would do, nor can the Staff predict how entities would change their practices in response to regulatory changes. The Staff also cannot estimate how many entities might opt for particular outcomes. The response of entities would depend on an interplay of factors such as the complexity of customer needs, the degree of customer engagement, entity resources, the current registration type of the entity, the extent to which broker-dealers have conflicts to be mitigated, eliminated or discharged, and competitive forces within the industry.[644] Finally, any ultimate and net costs on broker-dealers and investment advisers, which could be passed on retail customers, would depend not only on the specific rules that may be adopted and how the Commission might choose to define "personalized investment advice" but also on various factors, including, but not limited to, whether the intermediary in question is dually registered,[645] the extent of the intermediary's existing resources, and the size and business model of the intermediary.[646]

In addition, many commenters who addressed cost issues discussed only the potential for substantial costs associated with eliminating the broker-dealer exclusion, including the costs associated with converting retail commission-based accounts to fee-based advisory accounts. Most commenters did not address the costs associated with the approach recommended in the Study of extending a uniform fiduciary standard of conduct to broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors. To the extent commenters provided information about costs, their thoughts are addressed in this Section.

The cost analysis begins with a discussion below in sub-Section B of the costs of eliminating the broker-dealer exclusion. The Staff believes that this option, although not recommended, would present overall the greatest and most identifiable costs to both the broker-dealer industry and retail customers. Next, sub-Section C addresses the costs the Staff believes are most likely to be incurred if its recommendation of a uniform fiduciary standard of conduct were applied to broker-dealers and investment advisers. Finally, sub-Section D of the analysis discusses costs related to additional harmonization of the

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644 For example, the FSA found that smaller firms and firms with less revenue were more likely to either exit the market or alter the types of services provided, in response to new regulations including, *inter alia*, an enhancement in professional standards and establishment of a professional standards board. FSA Reports, id.

645 Generally, to the extent requirements of the investment adviser regime are imposed on broker-dealers, or vice versa, the Staff believes costs applicable to dually registered entities would be less than those applicable to the registrant type on which the requirements would be imposed. This is because dual registrants already comply with the requirements of both regimes and could apply their existing policies and procedures to each account as applicable.

646 According to Cerulli Associates, wirehouse and regional broker-dealers tend to devote less time to administrative tasks, more time to investment management activities, and a relatively equal proportion of their time to client-facing activities, when compared to bank broker-dealers, insurance broker-dealers and independent broker-dealers; as such, costs which would impact administrative tasks, for instance, would likely have more of an impact on the latter channels of broker-dealers. Cerulli Associates, Inc., Cerulli Quantitative Update: Advisor Metrics 2010, Exhibit 2.15 at 63.

regulatory regimes, beyond the parameters of the recommended uniform fiduciary standard.

Throughout this analysis, potential outcomes are discussed, such as changes in registration and conversion of customer accounts; the Staff does not believe that these outcomes would be mandated based on the uniform fiduciary standard of conduct outlined in the recommendations. These outcomes would be elective on the part of registrants, based on their particular business strategies, and how they decide to respond to regulatory changes. The Staff therefore believes that not all of the costs outlined under each of the three options would necessarily apply; where possible, the Staff has expressed its view on the likelihood of particular outcomes. Moreover, the Staff highlights that the net cost impact on intermediaries and retail customers alike would depend on the interplay of the various factors and potential outcomes set out below, as well as other factors beyond the scope of this Study, such as market forces and competition.

B. Potential Costs Associated with the Elimination of the Broker-Dealer Exclusion

1. Costs to Broker-Dealers

Eliminating the broker-dealer exclusion from the definition of investment adviser (Advisers Act Section 202(a)(11)(C)) would likely result in broker-dealers that provide investment advice having to register as investment advisers (either with the Commission or the states) and consequently incurring the associated regulatory costs, assuming they would wish to continue providing investment advice. Ultimately, however, the costs applicable to broker-dealers would depend on how they respond to an elimination of the exclusion. While the Staff is not recommending elimination of the broker-dealer exclusion, it has identified the following potential outcomes and associated costs of this option.

a) Potential Outcome 1: Broker-dealers might deregister, register as investment advisers, and in the process, convert their brokerage accounts into advisory accounts (subject to advisory fees).

Broker-dealers providing investment advice could choose to deregister as broker-dealers and only register as investment advisers.[647] The Staff anticipates that this option would be more likely for broker-dealers that perform limited broker-dealer functions, such as introducing brokers, than for broker-dealers who provide a greater range of

[647] Pursuant to the Dodd-Frank Act, investment advisers with under $100 million in assets under management would only be required to register at the state level, and so would incur costs to comply with applicable state investment adviser regulation but would not be subject to all of the requirements for federally registered investment advisers (such as certain rules promulgated under Advisers Act Section 206(4)).

broker-dealer services.[648] At least one commenter posited that elimination of the broker-dealer exclusion would "generate a spike in registration under the Advisers Act…impos[ing] additional regulatory costs and burdens on those new investment advisers."[649]

Broker-dealers that choose to deregister would have one-time costs associated with withdrawing from broker-dealer registration, including costs associated with completing and filing Form BDW. However, firms that deregister as broker-dealers would also eliminate ongoing compliance costs associated with complying with certain provisions of the Exchange Act, including: maintaining minimum net capital;[650] preparing and maintaining books and records (such as a stock record and trade confirmations for customers);[651] preparing periodic financial reports, annual financial statements and related audit fees;[652] paying SIPC and FINRA membership fees and other fees; complying with FINRA sales practice and other rules (such as complying with fidelity bond requirements and product-specific suitability obligations); requiring principal review of customer communications; complying with FINRA review of advertising; complying with fair pricing requirements; and being subject to FINRA and Commission examinations for compliance with the Exchange Act and SRO rules. Firms that deregister and register anew as investment advisers would instead become subject to the regulatory and compliance costs of being registered investment advisers, under the Advisers Act or the applicable state laws.

Deregistering would also lower ongoing compliance costs related to a broker-dealer's associated persons who would no longer be required to register as registered

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[648] For a fuller discussion of broker-dealer services, refer to sub-Section B.1.c, below. It is worth noting that firms that register as new investment advisers and deregister as broker-dealers would likely charge asset-based fees for their services rather than transaction-based fees, the receipt of which generally requires registration as a broker-dealer. Such registration would require that certain services the entity may have provided previously, which only broker-dealers can provide (such as execution and custody), would need to be provided by another entity; accordingly, both the costs and revenues associated with such operations would no longer apply to the newly registered investment adviser.

[649] See FINRA Letter, supra note 471 (stating that the elimination of the broker-dealer exclusion would "generate a spike in registration under the Advisers Act by current broker-dealers and their associated persons … impos[ing] additional regulatory costs and burdens on those new investment advisers, including additional state licensing, registration and examination requirements on some individuals."). See also IAA Letter, supra note 462 ("[T]here may be as many as approximately 230 [citing the Rand Report] additional broker-dealers that would be required to register under the Advisers Act or with the states if the broker-dealer exclusion was eliminated.… There would be some additional costs associated with SEC and state registrations."). See sub-Section B.4. below for a further discussion of the impact on Commission and State resources.

[650] Exchange Act Rule 15c3-1.

[651] Exchange Act Rules 17a-3 and 17a-4.

[652] Exchange Act Rules 17A-5(c) and 17A-5(d).

representatives, but this reduction could be offset by the costs of such persons then registering as investment adviser representatives.[653]

Firms that choose to register as investment advisers would incur the one-time costs of such registration. The registration process could result in costs for, among other things, the following procedural steps: (i) preparing and filing[654] Form ADV (including Part 2);[655] (ii) preparing and filing updates (yearly, or more frequently if material changes);[656] (iii) distributing client disclosures (as part of Form ADV Part 2, including the brochure supplement);[657] (iv) registering with states, as applicable;[658] and (v) identification and licensing (including any qualification exam) of investment adviser representatives in the states in which they do business. They would also be subject to other one-time administrative costs such as those associated with preparing new letterhead, revising compliance training, making public notices of the change in registration, revising employee contracts, and responding to customer inquiries.

Firms registered under the Advisers Act would incur ongoing costs associated with complying with that Act, including requirements and restrictions relating to custody, advertising, best execution, soft dollars, proxy voting, codes of ethics, cash solicitation (if they used solicitors), and principal trading.[659] In addition, firms registering as investment

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653 Specifically, firms would no longer have costs associated with: mandated training and passing FINRA qualification tests for firm personnel; conducting continuing education; and training associated persons for compliance with specific SRO sales practice rules. Instead, firms would have costs associated with state licensing of investment adviser representatives and training associated persons.

654 The filing fees range from $40 to $225 for the initial fee. See Approval of Investment Adviser Registration Depository Filing Fees, Investment Advisers Act Release No. 3119 (Dec. 2, 2010) ("Release 3119").

655 The Commission previously estimated that, for the average filer, the initial burden for preparing Form ADV would be 36.24 hours, in addition to one-time initial costs of outside legal fees, of $3,506.43, and of compliance consulting fees, of $3,621.91. Release 3060, supra note 67 at 83 and 85. The Commission also estimated that it would take an average filer 6.5 hours per year to prepare annual and interim amendments, which would be ongoing costs. Id. at 86 – 87.

656 The annual updating amendment fees range from $40 to $225. See Release 3119, supra note 654.

657 The Commission previously estimated that it would take an average filer 0.02 hours per customer to distribute this disclosure, and 0.1 hours per customer to distribute related interim updates. Based upon these estimates, the Commission estimated further that the average investment adviser would spend 33.1 hours per year complying with the delivery requirements of Form ADV. In addition, it noted that large filers may spend 200 hours per year to design and implement systems to track compliance with the delivery requirements of Form ADV. Release 3060, supra note 67 at 93 – 95.

658 Broker-dealers who may be required to register as investment advisers in multiple states may face added costs, and may elect to rely on the "Multi-state Adviser Exemption" in Advisers Act Rule 203(A)-2(e). Such election itself would impose costs associated with keeping records that demonstrate the entity would be required to register with 15 or more states.

659 See generally discussion in sub-Section B.1 above.

advisers may have to transfer assets to a qualified custodian, establish new brokerage relationships to execute trades, regularly reconcile accounts, and generate new appropriate documentation. In general, converting brokerage customer relationships to advisory relationships could entail significant time and expenditure on the part of the registrant, relating to, e.g., reviewing existing customer relationship documents, distributing notices, establishing new contracts with existing customers (e.g., repapering current customer agreements), and obtaining customer consents. It is possible that the registrant converting such accounts might lose some of its customers to competing broker-dealers that do not engage in such conversions. Moreover, on-going costs for newly registered investment advisers would include, among other things, modifying their supervisory and compliance structure to enforce compliance with the Advisers Act, including establishing written policies and procedures (such as a written code of ethics and tailored compliance policies and procedures), developing or acquiring new technology (as applicable) and hiring or retraining staff.[660]

It is worth noting that these costs could be offset by the savings associated with withdrawing from broker-dealer registration. And furthermore, to the extent the regulatory regimes governing broker-dealers and investment advisers were harmonized, over time the cost differential between being a broker-dealer and being an investment adviser would diminish, and possibly limit the costs of switching between the two roles.

b) Potential Outcome 2: Dual Registrants might convert their advised brokerage accounts to advisory accounts.

Broker-dealers that are currently dually registered as investment advisers and whose registered representatives are also investment adviser representatives might maintain broker-dealer registration, but convert some or all of their brokerage accounts to advisory accounts. Certain types of limited service accounts, such as execution-only accounts, would be less likely than other types of accounts to be converted. Dual registrants would incur the cost of applying Advisers Act requirements to the relevant accounts; however, being dually registered, such entities would not incur initial costs to the same extent as an entity registering as an investment adviser for the first time.[661] That said, such entities might need to modify the terms of their relationships with the relevant customers, which could nevertheless result in costs associated with modifying contracts, disclosure, and internal policies and procedures. Once the accounts were converted, the

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660 See SFVPMC Letter, supra note 471 (stating that the repeal of the broker-dealer exclusion "would impose significant new costs on existing broker-dealer firms that would have to register as investment advisers, design new compliance and supervisory systems and procure investment advisory representative licenses for their existing sales forces.")

661 In 2009, approximately 17% of broker-dealers were dually registered as investment advisers. See 2009 Special Committee Report at n.88. See also RAND Report, supra note 454 at 44 (noting that a review of IARD at the end of 2006 indicated that approximately 10% of broker-dealers reported that they were dually registered, and another 7 percent were state registered investment advisers). By mid-October 2010, approximately 18.4% of registered broker-dealer firms were dually registered investment advisers. See FINRA November Letter, supra note 41.

ongoing costs applicable to such accounts would derive from the currently applicable requirements of the Advisers Act, discussed above.

Other examples of costs that could be incurred in connection with converting accounts include: initially generating new appropriate documentation[662] (e.g., drafting new contracts, consents, and information memoranda to customers/clients, including the ongoing costs of distributing these forms and following up on their status); and, potentially transferring assets to a qualified custodian and performing account reconciliation.[663]

c) Potential Outcome 3: Broker-Dealers may unbundle their services and provide them separately through affiliates or third parties.

Broker-dealers might choose to unbundle their services and provide some of the component services through affiliates or third parties. A brokerage relationship involves several component functions: finding customers; providing advice to those customers; executing orders; providing clearance and settlement of the transaction; custodying the securities; and providing disclosure and recordkeeping services, such as customer confirmations and customer account statements. As such, costs to broker-dealers might depend on whether these services were provided by one entity or whether they were divided among service providers. For example, a broker-dealer or investment adviser can provide advice to an investor, but an investment adviser (unless dually registered) cannot execute an order. A broker can self-clear securities transactions, or contract with a clearing broker to clear transactions. In addition, a broker can custody securities itself or contract with a third party such as a bank to custody securities. Finally, a broker-dealer can disclose account information directly to investors, through an affiliate, or through a third party service provider.

Brokers could decide to divide some or all of these functions, such that one entity is responsible for providing personalized investment advice, and affiliates or third parties provide other services, such as trade execution and custody. Investment adviser representatives could also be broker-dealer employees as well as employees of a bank and an insurance agent depending on the holding company's business model. To the extent broker-dealers may transfer advised accounts or personnel to affiliated banks, they may incur the costs associated with deregistering, described above. Providing advice and associated order handling and back-office functions through an affiliated bank would generate administrative costs, and ongoing costs associated with complying with Regulation R under the Exchange Act.[664] In general, compliance with Regulation R, and

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662 See Release 2376, supra note 56 at 89.

663 See discussion of custody (Advisers Act Rule 206(4)-2) in sub-Section II.B.1.

664 For example, the bank could elect to rely on exceptions or exemptions from registration as a broker-dealer for trust or fiduciary activities or in connection with certain custody activities. Depending on which exception or exemption the bank relied, it would become subject to certain

any federal and/or state banking regulations to which the bank affiliate is not otherwise already subject, may result in additional costs.

d) Potential Outcome 4: Broker-dealers no longer buy or sell securities as principal from or to retail customers.

If the broker-dealer exclusion were eliminated, broker-dealers, as well as investment advisers affiliated with broker-dealers, might decide to no longer sell securities as principal to retail clients.[665] If so, they might lose the customers who seek that service to advisers that are not affiliated with broker-dealers, and also might lose underwriting revenue to the extent that underwriters were selected by some issuers because they could distribute not only to institutional customers but also to retail customers. Such loss in revenue could potentially manifest itself in increased costs to customers for other services and loss of investor choice, as discussed below in sub-Section B.3. For a further discussion relating to principal trading, see sub-Section C.3.a below.

2. Costs to Investment Advisers

The Staff does not expect that eliminating the broker-dealer exclusion would result in any direct costs to investment advisers.

3. Costs to Retail Investors, including Loss of Investor Choice

Eliminating the broker-dealer exclusion could generate direct costs to investors if firms changed their pricing structures or eliminated certain account features in response. For instance, to the extent that accounts were converted from commission-based accounts to fee-based[666] accounts, investors would become susceptible to higher costs in certain

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requirements, such as the compensation condition to the trust and fiduciary activities exception from broker-dealer registration, and may need to develop systems to ensure compliance with such requirements. Exchange Act Rules 721-723 under Regulation R.

665 Retail investors comprise a substantial proportion of investors holding securities, such as corporate and municipal debt securities, that are typically kept in broker-dealer inventories and sold through principal trades. For instance, SIFMA and Oliver Wyman highlighted the key role that broker-dealers play in the municipal bond market to retail investors, by noting that approximately 70% of municipal securities and 40% of corporate and foreign bonds are held by retail investors, with half of those securities held individually and the other half held in the form of pooled investments. See OW/SIFMA Study, supra note 643 at 18–19 (relying on Federal Reserve data), and note 694, infra.

666 For example, fees could be asset-based, fees for plans, hourly fees, and annual or retainer fees. In general, wirehouses and dually registered broker-dealers are more likely to receive fee-based compensation than transaction-based compensation, when compared to bank broker-dealers, independent broker-dealers, insurance broker-dealers and regional broker-dealers. See Cerulli Associates, Inc., Cerulli Quantitative Update: Advisor Metrics 2010, exhibit 2.13 at 61. Note that

circumstances, depending on how the broker-dealers elected to re-price their services.[667] Generally, investors pay broker-dealers either an "all-in" fee for a bundle of account services or pay for services separately. An "all-in" fee may be an asset-based fee, or commissions (including sales loads that may be supplemented by Rule 12b-1 fees) and mark-ups and mark-downs, or a combination of such fees. Investors also may pay separately for services such as, advice, trade execution, and custody. To the extent that accounts were converted or transferred from brokerage accounts (e.g., to investment advisory accounts or to managed agency accounts at affiliated banks), investors could incur additional direct costs from a changed pricing structure, whether the pricing structure remains as an "all-in" fee or whether investors pay separately for services.

If, in response to the elimination of the broker-dealer exclusion, broker-dealers elected to convert their brokerage accounts from commission-based accounts to fee-based accounts, certain retail customers might face increased costs, and consequently the profitability of their investment decisions could be eroded,[668] especially accounts that are not actively traded, e.g., fee-based accounts that trade so infrequently that they would have incurred lower costs for the investor had the accounts been commission-based. This practice is commonly referred to as "reverse churning" or "underutilization."[669]

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investors that pay asset-under-management fees for receiving investment advice should already be doing so in advisory accounts.

667 "It has been recognized that a commission-based, rather than fee-based, system of charges may pose a conflict as such a fee structure gives a retail securities broker an incentive to 'churn' a customer's account. By contrast, investment advisers' services are generally fee-based. It has also been recognized, in the broker-dealer context, that fee-based charges for a 'buy and hold' investor could result in considerably higher fees for such an investor over time, which is certainly not in the client's best interest." NSCP Letter, supra note 503.

668 "[A] 1% increase in annual fees reduces an investor's return by approximately 18% over 20 years." Enhanced Disclosure and New Prospectus Delivery Option for Open-End Investment Companies, Investment Company Act Release No. 28064 at note 46 (Nov. 21, 2007). See OW/SIFMA Study, supra note 643 at 26 (indicating that, given certain assumptions, "[t]he shift to a fee-based model would reduce cumulative returns to 'small investors' (with $200K in assets) by $20K over the next 20 years").

669 FINRA, NASD and NYSE have brought a number of disciplinary actions against broker-dealers for reverse churning. See, e.g., NYSE Regulation Fines A.G. Edwards & Sons $900,000 for Charging Customers Excessive Account Fees and Other Violations, Aug. 7, 2006, available at http://www.nyse.com/press/1154686574106.html, (censuring and fining a broker-dealer for "improperly maintaining customers in non-managed fee-based accounts and charging customers excessive fees, in light of the trading activity in those accounts."). See also NASD Fines Raymond James $750,000 for Fee-Based Account Violations, in NASD NTM Disciplinary Actions, May 2005, available at http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p014114.pdf (censuring and fining a broker-dealer for "fail[ing] to establish and maintain a supervisory system, including written procedures, reasonably designed to review and monitor their fee-based brokerage business"). See also NSCP Letter, supra note 503 ("It has been recognized that a commission-based, rather than fee-based, system of charges may pose a conflict as such a fee structure gives a retail securities broker an incentive to 'churn' a customer's account. By contrast, investment advisers' services are generally fee-based. It has also been recognized, in the broker-dealer context, that fee-based charges for a 'buy and hold' investor could result in considerably

Ultimately, reverse churning reduces the profitability of affected accounts to the customers. Between 2004 and 2009, FINRA disciplined ten firms in connection with reverse churning, imposing over $7 million in fines and ordering over $9.5 million be paid in restitution to investors.[670] Conversely, conversion to fee-based accounts could result in lower costs and corresponding increased profitability for retail investors who trade often.

Commenters stated that conversion to fee-based accounts would increase costs to retail investors and limit their choice in services currently available, as the cost of services becomes prohibitively high.[671] At least two commenters also stated that broker-dealers might pass along their costs associated with registering as investment advisers to their customers, and reduce investor access to certain products and services.[672] One commenter also argued that subjecting broker-dealers to the principal trading restrictions

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higher fees for such an investor over time, which is certainly not in the client's best interest."). As a result, rules were enacted requiring broker-dealers to manage and monitor accounts to prevent this practice (i.e., to ensure that relatively inactive accounts are held as commission-based accounts rather than fee-based accounts).

670 These violations were detected by FINRA in the course of both enforcement sweeps and non-sweep fee-based matters. The disciplinary actions were based upon violations of NASD Rules 3010 (Supervision), 2110 (Standards of Commercial Honor and Conduct, since superseded by FINRA Rule 2010), 2430 (Charges for Services Performed), and 2210 (Communications with the Public). The sanctions totaled $7,357,000 in fines in addition to, in certain cases, undertakings and suspension. The restitution payments totaled approximately $9,546,0078.56, plus interest in all but one case. Letter from Kathleen A. O'Mara, FINRA, to Kristen Lever, U.S. Securities and Exchange Commission, re: Dodd-Frank Wall Street Reform and Consumer Protection Act, dated Dec. 6, 2010.

671 Securian Letter, supra note 553 ("Existing business models that currently offer customers a choice between a lower cost transaction-based relationship with a broker-dealer and a higher cost continuous-service relationship with an investment adviser may also be disrupted if broker-dealers and their costs of doing business are pushed closer to the investment adviser model. Such disruptions would not only raise costs and rob customers of choices they enjoy today, but many low and middle-income customers may lose even the opportunity to realize the intended 'benefit' of a new fiduciary standard if the cost of service becomes prohibitively high relative to their levels of income."). It is worth noting, however, that to the extent some broker-dealers may alter their business models to be closer to the investment advisory model, other broker-dealers may not, and may still offer relatively lower cost services to investors that are akin to transaction-based services. Accordingly, it is possible that across the industry, overall investor choice may not diminish.

672 See SFVPMC Letter, supra note 471 (predicting that "additional costs would squeeze already thin margins for broker-dealers that serve the non-affluent market, and perhaps make product offerings less available to a market that traditionally has been underserved. Repeal of the broker-dealer exclusion could also result in increased regulatory costs being passed on to customers."). See also Commonwealth Letter, supra note 476 (stating that "the time and costs associated with the registration process [resulting from elimination of the broker-dealer exclusion] would be overly burdensome and unnecessary. Furthermore, the ongoing costs of maintaining the required licenses and registrations would necessarily be passed on to investors.").

that currently apply to investment advisers would have the ultimate effect of increasing trading costs to retail investors on an ongoing basis.[673]

A number of industry commenters argued that the elimination of the broker-dealer exclusion or the imposition of the standard of conduct under the Advisers Act and other requirements could lead to a reduction in investor choice in products and services, how investors pay for such products or services, or both.[674] At least one commenter claimed that either of these alternatives (without the creation of exemptions) could result in an inability of broker-dealers to offer certain products and services, including: cash sweep services; discount and unsolicited brokerage services; underwriting; proprietary product sales; principal trading; and incidental advice in connection with non-discretionary accounts for commissions.[675] In particular, some brokerage industry commenters stated that if the broker-dealer exception were repealed, firms might choose to cease offering financial services to less affluent retail customers, because it would not be economically viable to offer services to such customers if firms had to register as investment advisers, design new compliance systems, and incur other costs as a result.[676] Other commenters noted that the elimination of the broker-dealer exclusion could reduce the research services available, as broker-dealers may become concerned that such research might constitute personalized investment advice requiring registration with the Commission or with the states.[677] Commenters also suggested that subjecting registered representatives to the Advisers Act would limit retail investor access to services and products that are offered through a commission-based compensation model.[678]

While some commenters anticipated that such loss of investor choice would particularly impact less affluent investors, others noted that such investors are already

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673 See FINRA Letter, supra note 471 ("[B]roker-dealers provide an important liquidity function by buying and selling securities from their own account. The Advisers Act prohibits an investment adviser from acting as principal for his own account without disclosing to such client in writing the capacity in which he is acting before completion of the transaction and obtaining the consent of the client to the transaction. Thus, if the Commission imposes on broker-dealers the identical investment adviser application of a fiduciary duty to retail customers, it would force broker-dealers to either cease providing investment advice to retail customers or forego one of the defining aspects of the broker-dealers model that significantly contributes to market liquidity and efficiency. Both of those repercussions inure to the detriment of retail customers: the former would reduce competition for financial services and might deprive customers of continued association with the financial professional or firm of their choice; the latter could reduce market liquidity and increase volatility and raise trading costs to retail customers.").

674 See, e.g., FSI Letter, supra note 471; NAIFA Letter, supra note 552; Schwab Letter, supra note 19; Wells Fargo Letter, supra note 17.

675 See, e.g., LPL Letter, supra note 471.

676 See, e.g., Commonwealth Letter, supra note 476; SFVPMC Letter, supra note 471.

677 See, e.g., FINRA Letter, supra note 471. But see, infra, the Staff's recommendation with respect to personalized investment advice.

678 See, e.g., NAIFA Letter, supra note 552.

served by investment advisers, who have a wide and diverse client base.[679] Commenters also pointed to the experience of financial planners, who initially resisted application of the Advisers Act fiduciary duty to their sales of financial products and securities, but who continue to be able to offer their products and services under the Advisers Act.[680] Commenters noted that simply because some broker-dealers may choose to cease offering certain services and products if subjected to the Advisers Act does not necessarily mean that access to those services would be reduced, as the products and services would still be available from other sources.[681] Conversely, to the extent there is a reduction in broker-dealers willing to offer certain products and services, costs could increase.[682]

4. Impact on Commission and State Resources

Any increases in the number of investment adviser registrants resulting from the elimination of the broker-dealer exclusion would add strain to the Commission and state resources dedicated to the examination of investment advisers and representatives of registered investment advisers, and to related enforcement efforts.[683]

C. Potential Costs Associated with Staff Recommendation to Consider Rules Applying a Standard of Conduct No Less Stringent than Advisers Act Sections 206(1) and 206(2) to Broker-Dealers, Investment Advisers and their Respective Associated Persons.

If, as this Study recommends, the Commission exercises its authority under Section 913 to apply a uniform fiduciary standard to broker-dealers that is no less stringent than Advisers Act Sections 206(1) and 206(2), broker-dealers offering and maintaining brokerage accounts would incur additional costs associated with complying

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679 See, e.g., Financial Planning Coalition Letter, supra note 471.

680 See, e.g., AARP Letter, supra note 449; CFA Letter, supra note 450. See also letter from Steven Doster, Certified Financial Planner, dated Aug. 26, 2010 ("Adhering to the fiduciary standard of care does not limit my ability to provide my clients with appropriate services. Providing financial advice with fiduciary accountability does not reduce services to middle-class people. It insures that the services consumers receive will be in their best interests – not in the best interests of the financial intermediary or his or her company.").

681 See, e.g., CFA Letter, supra note 450.

682 See, e.g., LPL Letter, supra note 471 ("[Elimination of the broker-dealer exclusion] also could limit customer choices, as discount brokerage services and incidental brokerage transactions could become scarce and more expensive.").

683 The Section 914 Study addresses the costs associated with Commission and state resources and takes into account, for the short term, a reduction in the number of federally registered investment advisers as a result of the implementation of Dodd Frank Act Section 410. The Section 914 Study does not take into account any increase in the number of federally registered investment advisers that would result from elimination of the broker-dealer exclusion, which would otherwise augment the assessments of costs and impact on Commission and State resources as stated therein. See Section 914 Study and Commissioner Walter Statement, supra note 3.

with that standard with respect to brokerage accounts for which they provide personalized investment advice about securities.[684] However, the extent of these costs would depend on the rules that were ultimately adopted, as well as on the way broker-dealers and investment advisers decide to respond to such a standard, and the extent to which any increased costs might be passed on to retail customers. Several commenters expressed a view that imposing a fiduciary standard would generally increase administrative and compliance costs to broker-dealers.[685] As the uniform fiduciary duty is implemented over time, it may be that administrative and compliance costs to broker-dealers are diminished. The Staff has identified certain potential responses, or outcomes, and their associated costs, as set forth below.

1. Costs to Broker-Dealers

a) Potential Outcome 1: Broker-dealers may continue to offer and maintain brokerage accounts subject to the new standard of conduct.

The Staff believes it is less likely that many broker-dealers would implement major changes to their businesses in response to the imposition of the uniform fiduciary standard recommended in this Study than they would in response to the elimination of the broker-dealer exclusion, as discussed above in sub-Section B. The Staff believes this is because the adoption of a uniform fiduciary standard would not represent as fundamental a change for broker-dealers as would the elimination of the broker-dealer exclusion. As such, one potential outcome is that broker-dealers might continue to offer and maintain brokerage accounts that would become subject to the new standard. At least one commenter highlighted anticipated costs of complying with a new standard of conduct, including initial costs of amending disclosures, preparing new account documentation, and amending training and policies and procedures, which in turn could increase ongoing costs relating to certain "back-office" functions, such as modification of supervision and

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684 It is worth noting that some commenters questioned whether costs to broker-dealers would really increase upon imposition of any new standard of conduct, or elimination of the broker-dealer exclusion discussed above. But see, fi360 Letter, supra note 572 ("[I]n relation to claims that compliance burdens and costs would increase, have brokers provided actual numbers and statistics to back their claims? For advisers that have served as fiduciaries, what is it that has made their business sustainable and what practices have they employed to manage the costs associated with compliance?"). On the other hand, at least one commenter stated that costs would be imposed not only for complying with a new standard, but also with demonstrating such compliance. See OW/SIFMA Study, supra note 643.

685 See NAIFA Letter, supra note 552 (stating that the "imposition of an ambiguous fiduciary obligation would likely require many NAIFA members to increase significantly the time and resources they devote to regulatory compliance…. [L]ayering on an additional standard of care on broker-dealers would do little to discourage improper conduct. Instead, its consequences would be largely concentrated on well-intentioned financial professionals, increasing their administrative costs….").

surveillance reports.[686] In connection with compliance, some broker-dealers might choose to hire additional staff and amend internal supervisory structures.

In addition, in complying with a new standard, broker-dealers initially would incur costs in order to conduct an assessment of their business practices, review any conflicts of interest, and determine what changes, if any, were needed to their customer agreements and disclosures and other business practices.[687] Several commenters concurred stating that any change in the standard of conduct would significantly increase costs to broker-dealers.[688] For example, one commenter predicted that the imposition of a new standard of conduct would result in increased compliance costs associated with reviewing existing customer relationships, and agreeing on new investment plans or obtaining consent to continue existing strategies for customers.[689] Other commenters expressed concern with potential increased litigation expenses associated with the imposition of a fiduciary standard of conduct.[690] However, FINRA reported that breach of fiduciary duty allegations currently are the most frequent cause in arbitrations.[691]

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686 Hartford Letter, supra note 471 ("Any transition to address all of the items outlined in the proposal for revised standards will result in significant costs and change in the form of disclosures, new account paperwork/applications, training and policies and procedures. It is conceivable that many of the changes contemplated will have significant implications for back-office systems (e.g., modification of supervision and surveillance reports, commission systems, etc.). These changes could also directly or indirectly affect the potential exposure of insurance companies that distribute their products through broker-dealers. The SEC must adequately consider these costs in relation to the benefits of any proposed rules.").

687 For instance, absent further Commission guidance, broker-dealers that continue to engage in principal trading under the new standard of conduct recommended by the Staff would be required to disclose the conflicts of interest related to such principal transaction, including their capacity as principal, even though they would not be subject to the specific procedural requirements set forth in Advisers Act Section 206(3).

688 See, e.g., IIABA Letter, supra note 552 ("Altering the existing standard…[will cause m]any broker-dealers and registered representatives…[to] simply cease their securities-related operations given the uncertainty associated with such an amorphous and subjective standard, higher compliance and insurance costs, and well-founded fears about increased liability exposure.").

689 OW/SIFMA Study, supra note 643 at 27.

690 NAIFA Letter, supra note 552 (Stating that "eliminating the broker-dealer exclusion would also force NAIFA members to protect themselves against what will undoubtedly be a substantial increase in frivolous litigation. A broker-dealer fiduciary duty may lead to costs that substantially exceed those of litigation under Section 36(b) [of the Investment Company Act], particularly because the standard is not precisely defined. Such costs would be catastrophic for [NAIFA] members, and would likely force many of them to shut down their operations."). The NAIFA Letter also makes an analogy in the same discussion to the imposition of a fiduciary duty on mutual fund investment advisers (Section 36(b) of the Investment Company Act) which has resulted in "hundreds of cases [being brought,] imposing billions of dollars in costs without a single plaintiff victory at trial."

691 FINRA reported that breach of fiduciary duty has been the most frequent cause of action among all its arbitration cases served in 2009. See supra note 384.

Similarly, a number of commenters have indicated that application of a fiduciary standard to broker-dealers would increase insurance costs for broker-dealers (and ultimately their customers).[692] None of the commenters quantified the costs or gave a range of costs that they would incur under a fiduciary standard of conduct. In general, to the extent costs were to increase for broker-dealers, and assuming their brokerage accounts in question remained commission-based and the trading frequencies in those accounts did not change, one would expect the profitability to the broker-dealer of such commission-based accounts to decrease.

b) Potential Outcome 2: Broker-dealers might deregister and register as investment advisers and, in the process, convert their brokerage accounts into advisory accounts (subject to advisory fees).

It is possible that broker-dealers providing investment advice may choose to deregister as broker-dealers and only register as investment advisers. The costs associated with this potential outcome are discussed above in sub-Section B.1.a.

In addition, some commenters specifically addressed the potential for converting accounts from commission-based accounts to fee-based accounts.[693] They stated that such conversion would result from changes in broker-dealer business models upon any imposition of a new standard of care on broker-dealers. The ultimate cost impact of this would depend on the actual fees and commissions, the relative extent to which the accounts in question had been actively trading, and any increased costs associated with providing advice for a fee (i.e., the advice model could change and its costs would change as well). That said, to the extent that in newly converted fee-based accounts "fee layering" (whereby fees are charged based both on the value of the assets as well as account fees (e.g., administration and custodial fees) becomes prevalent, especially for less actively traded accounts, such conversion from commission-based accounts might increase revenues for broker-dealers, thereby offsetting, partially or entirely, any cost increases otherwise resulting from imposition of the new standard of conduct.

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692 See, e.g., Commonwealth Letter, supra note 476 ("Adopting a uniform standard of care…would open the floodgates of litigation, increasing errors and omissions insurance premiums for brokers and dealers. These costs would necessarily be passed on to investors in the form of higher fees or commissions….[S]mall retail investors – who arguably have the greatest need for sound investment recommendations – will have decreased access to financial professionals who are willing to expend the time and incur the added cost, and they will find themselves abandoned."). See also 2005 Adopting Release, note 210 at 20444 (The Commission reported in 2005 that one commenter had indicated that underwriting errors and omissions ("E&O") insurance claims "against broker-dealers were twice as frequent and twice as severe as comparable claims against investment advisers.").

693 See letters from Robert E. Thompson, CLU, ChFC, NAIFA, and Gregory V. Cismoski, dated Aug. 12, 2010 ("Driving every registered representative to fee-only compensation will not necessarily result in better, unbiased advice for the consumer.").

c) Potential Outcome 3: Dual registrants might convert their advised brokerage accounts to advisory accounts.

Broker-dealers that are already dually-registered could choose to convert their advised brokerage accounts to advisory accounts. The costs associated with this potential outcome are discussed above in sub-Section B.1.b.

d) Potential Outcome 4: Broker-Dealers might unbundle their services and provide them separately through affiliates or third parties.

Broker-dealers might choose to unbundle their services and provide some of the component services through affiliates or third parties. The costs associated with this potential outcome are discussed above in sub-Section B.1.c.

2. Costs to Investment Advisers

Application of the new standard is unlikely to result in any direct costs to investment advisers, especially in light of the fact that the recommended standard that would be applied to both broker-dealers and investment advisers would be consistent with standards already applicable to investment advisers under Advisers Act Section 206(1) and 206(2). That said, any additional requirements that might be imposed on investment advisers in light of the existing regulatory gaps might result in additional costs for them; such costs are discussed below in sub-Section D.

3. Costs to Retail Investors, including Loss of Investor Choice

a) Intermediaries might pass along costs to retail investors and/or reduce services and products they offer to retail investors.

The cost to retail investors of applying a new standard would depend on the specific obligations imposed under that standard, and would largely depend on the extent to which costs on intermediaries are passed on to them. Even the level of costs on intermediaries would be expected to vary widely across the industry, based on the particular business models and other facts and circumstances applicable to each entity. As such, some intermediaries might experience relatively less in terms of additional costs (if any) upon imposition of a new standard of conduct, which could give those intermediaries a competitive advantage over other intermediaries. For example, any self-imposed restrictions on selling securities out of firm inventory, as chosen by the broker-dealer with the aim of avoiding conflicts of interests and adhering to a new standard, may increase costs to retail investors. If, as a result of such restriction, firms decide not to sell securities as principal, that can potentially lower the quality of execution of transactions. As a result of any new conflicts of interest restriction, broker-dealers may stop trading on a principal basis in certain securities, such as bonds that are not exchange traded,

potentially depriving investors of the best possible execution. While that may have less of an impact for certain securities (e.g., highly liquid securities such as exchange-traded equities) the debt market is a dealer market and the costs associated with purchasing certain securities, particularly less liquid securities, as agent, may increase execution costs for some investors, namely those customers of broker-dealers who otherwise had maintained inventories of such securities.[694]

Several commenters expressed concerns that a new standard of conduct or new regulatory requirements might significantly increase costs for broker-dealers, which would then be passed on to retail investors.[695] In turn, costs passed on to retail investors would have the effect of eroding the profitability of their investments.[696] For example, some commenters indicated that litigation would increase under a new standard of conduct, that this, in turn, going forward would increase the cost of insurance for the firm, and that such a cost would be passed on to the firm's customers.[697] None of the commenters provided any quantification of such anticipated costs. To the extent that a particular relationship between a broker-dealer and a customer changed as a result of imposition of the new standard of conduct, it is possible that a retail investor's profitability might increase. However, the extent of any impact of the new standard may have on retail investor profitability would be determined by a number of factors, including the costs associated with the standard.

Commenters speculated that, ultimately, the increase in costs to broker-dealers could cause many to decide to no longer offer certain products and services to retail

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694 According to FINRA, excluding convertible bonds and equity CUSIPs, 84% of investment grade corporate bond trades in the secondary market are principal trades, and in terms of par value traded, 98% of investment grade corporate bonds in the secondary market are traded as principal. FINRA, TRACE Fact Book 2010 Quarterly Table for the third quarter, available at http://www.finra.org/Industry/ContentLicensing/TRACE/P085342. According to the MSRB, in 2010 approximately 90.8% of municipal bond trades were effected on a principal basis (with the remainder being effected on an agency basis). Letter from Marcelo Vieira, MSRB, to Matthew Kozora, U.S. Securities and Exchange Commission, dated Jan. 11, 2011.

695 See, e.g., Commonwealth Letter, supra note 476; FSI Letter, supra note 471; Hartford Letter, supra note 471; Morgan Stanley Letter, supra note 39; Securian Letter, supra note 553; Woodbury Letter, supra note 471.

696 See OW/SIFMA Study, supra note 643 at 26 (purporting that, assuming broker-dealers will change their business models from a commission-based model to a fee-based model in response to a new standard of conduct, and also given certain assumptions about and categorizations of retail customers, cumulative returns to retail customers with $200,000 in assets would reduce by $20,000 over the next 20 years). But see letter from Barbara Roper, Consumer Federation of America, dated Nov. 2, 2010 ("CFA Letter 2") (criticizing the Oliver Wyman/SIFMA Study for basing its assertions as to costs on an unfounded assumption that broker-dealers would respond to a new standard of conduct by no longer charging commissions; and for basing its estimates of additional costs that would apply under a new standard of care on requirements that already apply to broker-dealers under the current regulatory regime).

697 See Commonwealth Letter, supra note 476; Release 2376, supra note 56.

customers (e.g., due to risk of litigation under a new fiduciary standard, or due to restrictions on principal trading), or would only offer them at increased prices, thereby limiting retail customers' access to the currently available range of products and services.[698] One commenter went further to state that the imposition of specific rules in connection with a best interest standard would ultimately increase costs to retail investors for even basic services.[699] Other commenters countered that the costs and impact on investor choice would be *de minimis*.[700]

The Staff believes that its recommended uniform fiduciary standard recognizes the value of preserving investor choice with respect to the variety of products and services involving the provision of investment advice and how investors may pay for them. Furthermore, the recommended uniform fiduciary standard would be limited to activities that specifically involve the provision of "personalized investment advice," and therefore would not result in a broad application of Advisers Act requirements to broker-dealer services that do not involve the provision of personalized investment advice.[701] The Staff believes that the recommended uniform fiduciary standard would not require that broker-dealers limit, nor would it necessarily result in broker-dealers limiting, the range of products and services they currently offered to retail investors.

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698 See IIABA Letter, supra note 552 ("Many middle class Americans – especially those unwilling or unable to pay upfront fees for guidance – will effectively lose access to competent financial guidance and certain investment products and services."). See also OW/SIFMA Study, supra note 643 at 29 (stating that under a new fiduciary standard of conduct, the availability of services currently provided by broker-dealers, including sale of municipal and corporate bonds, would become limited due to capacity constraints on the industry brought about by increased costs).

699 See Schwab Letter, supra note 19 ("[B]eyond the baseline requirement of a best interest standard, specific prescriptive rules attempting to govern the duty of care would run a serious risk of either being over-inclusive or under-inclusive in terms of application to the vast range of advice services available to retail customers today…. Over-inclusiveness would essentially alter the contract between the customer and firm, in some cases likely driving driving [sic] driving-up the cost of providing basic non-discretionary advice services. This includes the potential cost in defending a minority of misplaced claims alleging violation of a fiduciary duty for failing to supervise or monitor an account, despite a contractual arrangement between the firm and customer which limits the broker's role given the small commission or fee the customer pays").

700 See CFA Letter, supra note 450 ("[S]ome industry members have argued against imposition of a fiduciary duty on the grounds that it would increase investor costs. They have offered no evidence to support this contention, however, which is based in part on a false assumption that such a requirement would inevitably lead to adoption of fee-based compensation and which ignores the potential benefits of a fiduciary duty in disciplining excessive costs."); NASAA Letter, supra note 428 ("The states believe that if there is any concomitant increase in compliance costs incurred as the result of subjecting Broker-Dealers to a fiduciary duty standard, it will be *de minimis*. The direct benefits to investors from adopting this standard will greatly exceed any foreseeable costs".). See also CFA Letter 2, supra note 696 (criticizing the OW/SIFMA Study for making an unfounded assumption that imposition of a fiduciary standard would impose the same restrictions on principal trading as those currently found in the Adviser Act, and that such restrictions would cause customers to lose access to products primarily sold on a principal basis, such as municipal and corporate bonds).

701 See, e.g., CFA Letter, supra note 450; Financial Planning Coalition Letter, supra note 471.

In connection with its consideration of potential loss of investor choice, the Staff also considered whether potentially underserved portions of the retail investor population, such as those located in rural areas, might be adversely affected by any of the options considered under Section 913. The Staff believes that for the same reasons stated in the aforementioned paragraph the recommended uniform fiduciary standard would in and of itself, not adversely impact such populations' access to financial products and services.

Certain commenters noted that the application of a new standard that is vague, because of its lack of clarity, would result in overall increased costs to retail investors, possibly to the extent that the price for such products and services would become prohibitively expensive to middle class retail investors.[702] However, given that the Staff recommends that the new standard be conveyed through rulemaking and supplemented with Commission or Staff guidance to assist broker-dealers and investment advisers in applying the standard, this concern would be addressed by proposed Commission action going forward.

One possible way that costs could increase is if broker-dealers whose customers want advice and who currently provide the full range of brokerage services outlined above in sub-Section B.1.c for a single commission (or mark-up) and perhaps minor account level fees, simply converted these accounts to investment adviser status and cease to provide execution services to retail investors who sought advice. If that were the case, custody costs to the retail investors would be higher. Advice costs charged, at least initially upon conversion (and absent the investor researching competitors' prices), would also be higher for those investors who buy and hold, because either an hourly or asset-based fee would likely exceed the current commission or mark-up on a retail trade.

In sum, to the extent that broker-dealers respond to a new standard by choosing from among a range of business models, such as converting brokerage accounts to advisory accounts, or converting them from commission-based to fee-based accounts, certain costs might be incurred, and ultimately passed on to retail investors in the form of higher fees or lost access to services and products. Any increase in costs to retail investors detracts from the profitability of their investments.

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[702] See Hartford Letter, supra note 471 ("If an unclear standard is substituted for a clear one, an inevitable effect will be reduced efficiency among financial service providers. This will result from several overlapping factors. One is increased litigation. The result of that will result in increased financial costs of doing business and excessive costs of time expended in self-defense (just as was experienced in the U.K). These increased costs will cause providers to exit the field, especially providers who serve the middle markets. . .persons with between $1,000 and $250,000 to invest."). See also NAIFA Letter, supra note 552 (stating that the "imposition of an ambiguous fiduciary obligation would likely require many NAIFA members to increase significantly the time and resources they devote to regulatory compliance…. [L]ayering on an additional standard of care on broker-dealers would do little to discourage improper conduct. Instead, its consequences would be largely concentrated on well-intentioned financial professionals, increasing their administrative costs….").

D. Potential Costs Associated with the Application of Additional Harmonized Standards Beyond those Associated with sub-Section C

To the extent that additional standards were harmonized beyond those set out in the Staff's recommended uniform fiduciary standard, it is likely that there would be additional costs on broker-dealers and investment advisers, as applicable, and on retail customers. Ultimately, the costs associated with additional harmonized standards would depend on various factors, including which and how many standards are harmonized, whether the harmonization had an overall greater impact on broker-dealers or on investment advisers, how broker-dealers and investment advisers decide to respond to such harmonization (e.g., by pursuing any of the potential outcomes described above, or others not contemplated in this Study), and the extent to which any increased costs on intermediaries (i.e., broker-dealers and investment advisers) were passed on to retail customers.

1. Costs to Broker-Dealers

If broker-dealers did not deregister or transfer accounts but rather choose to remain registered and regulated as broker-dealers (as described above in sub-Section C.1.a), there would still be costs related to the harmonization of regulations governing broker-dealers and investment advisers, which several commenters addressed.[703] The costs associated with the inclusion of obligations beyond those encompassed in a "no less stringent" standard would depend on which obligations would ultimately comprise the standard.

For instance, commenters noted that the following specific compliance obligations, if harmonized, could impose ongoing costs on broker-dealers: applying a revised principal trading rule; and harmonizing customer disclosures (e.g., at account opening).[704] That said, in general, harmonization of the two regulatory regimes over time would mitigate or reverse any cost differentials between broker-dealers and investment advisers, and their respective customers. Commenters were also concerned about expenses associated with harmonizing remedies to retail investors, such as establishing a private right of action.[705]

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703 Note however that at least one commenter highlighted cost as a reason to harmonize the regulation of broker-dealers and investment advisers. See Schwab Letter, supra note 19 ("Applying two comprehensive regulatory schemes to the same conduct will result in unnecessary costs and increased confusion to retail customers, and likely would diminish retail customer access to products and services that they enjoy today.").

704 The level of initial and ongoing costs relating to harmonization of disclosure requirements would depend on the frequency, timing, content and level of detail required by the harmonized disclosure requirement.

705 See, e.g., PIABA Letter, supra note 482.

2. Costs to Investment Advisers

Commenters suggested that additional harmonization could involve the harmonization of competency and continuing education requirements,[706] which if it were based on the broker-dealer business conduct requirements, would increase both initial and ongoing costs to investment advisers. Such costs might not be significant, however, because investment adviser representatives generally already are subject to competency and continuing education requirements in some states.

Other areas for harmonization, which would likely impose some level of additional costs on investment advisers, include available remedies, registration, and requirements on advertising, supervision, financial responsibility, licensing, and books and records. Commenters specified compliance obligations that, if fully harmonized to conform with the standards now applicable to broker-dealers, would impose additional ongoing costs on investment advisers, including, among others: additional supervisory requirements;[707] additional advertising regulation;[708] additional books and records requirements;[709] and applying certain financial responsibility requirements (such as fidelity bond requirements).[710] The associated additional costs would typically involve at least one-time costs to adjust to the harmonized requirements, and to some extent additional on-going compliance costs.

Several commenters stated that harmonization could lead to the imposition of an SRO for investment advisers.[711] Any such SRO membership would subject advisers to additional expenses, including but not limited to membership fees. One commenter specifically cited cost as one of the reasons why an SRO for investment advisers should be opposed.[712] For a further discussion of this issue, please refer to the Section 914 Study.[713]

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706 See, e.g., AALU Letter, supra note 472; BOA Letter, supra note 17; FSI Letter, supra note 471; Hartford Letter, supra note 471; LPL Letter, supra note 471]; UBS Letter, supra note 39; Woodbury Letter, supra note 471.

707 See, e.g., AALU Letter, supra note 472; CAI Letter, supra note 26.

708 See, e.g., FINRA Letter, supra note 471; FSI Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39.

709 See, e.g., FSI Letter, supra note 471; LPL Letter, supra note 471.

710 See, e.g., BOA Letter, supra note 17; FSI Letter, supra note 471; LPL Letter, supra note 471; UBS Letter, supra note 39.

711 See, e.g., Commonwealth Letter, supra note 476; FINRA Letter, supra note 471; FSI Letter, supra note 471. Dodd-Frank Act Section 914 requires the Commission to study, among other things, the extent to which having Congress authorize the Commission to appoint one or more SROs would augment the Commission's efforts in overseeing investment advisers. See also Section 914 Study and Commissioner Walter Statement, supra note 3.

712 See IAA Letter, supra note 462. See also Section 914 Study and Commissioner Walter Statement, supra note 3.

3. Costs to Retail Investors, including Loss of Investor Choice

The costs to retail investors of additional harmonization of the broker-dealer and investment adviser regulatory regimes would ultimately depend on a number of factors, including exactly which requirements were harmonized, how those requirements are harmonized, how the relevant intermediaries responded to such harmonization, and the extent to which any increased costs on intermediaries were passed on to their retail customers. [714]

Generally speaking, to the extent the harmonization of a regulatory requirement essentially involves imposing a requirement currently applicable to intermediaries of one regime to intermediaries in the other, costs for the retail customers of the latter regime would likely increase. That said, such costs would likely be reduced to the extent the intermediary in question were dually registered or otherwise already has processes in place to ensure compliance with the harmonized requirement, or a comparable requirement. Commenters generally did not address whether or how additional harmonization of the broker-dealer and investment adviser regulatory regimes would impact investor choice.

VI. Conclusion

Despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities. Retail customers should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations. Instead, retail customers should be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. At the same time, it is necessary that such protection allows retail customers to continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide.

Therefore, this Study recommends that the Commission exercise its rulemaking authority to adopt and implement, with appropriate guidance, the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. In addition, the Study recommends that when broker-dealers and investment advisers are performing the same or substantially similar functions, the Commission should consider whether to

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713 See Section 914 Study and Commissioner Walter Statement, supra note 3.

714 Commenters have suggested that costs associated with harmonization, such as the ongoing costs of investment advisers complying with suitability and other SRO rules, would likely be passed on to retail investors. See, e.g., FSI Letter supra note 471 and LPL Letter supra note 471.

harmonize the regulatory protections applicable to such functions. Such harmonization should take into account the best elements of each regime and provide meaningful investor protection.

The Staff's recommendations were guided by an effort to establish a uniform standard that provides for the integrity of personalized investment advice given to retail investors. At the same time, the Staff's recommendations are intended to minimize cost and disruption and assure that retail investors continue to have access to various investment products and choice among compensation schemes to pay for advice.

The views expressed in this Study are those of the Staff and do not necessarily reflect the views of the Commission or the individual Commissioners.

Appendix A: Regulatory, Examination and Enforcement Resources Devoted to Enforcing Standards of Care for Providing Personalized Investment Advice and Recommendations

I. Commission and SRO Regulatory, Examination and Enforcement Resources

A. Recent Commission Developments to Enhance Effectiveness of Examinations

During the past year, OCIE has instituted several changes to its examination program and has plans for significant additional strategic initiatives, all to increase the effectiveness and efficiency of the national exam program.[1] In March, OCIE launched an intensive nationwide self-assessment process. OCIE reviewed the examination program by looking at the five components of: strategy; structure; people; process; and technology. Since July, OCIE has moved quickly to implement additional reforms from the nationwide self-assessment.[2] Although success of these reforms depends greatly on the funding and resources made available to OCIE, the following enhancements speak to the increased focus on empowering examiners, inter- and intra-office coordination, internal oversight, and conducting risk-based examinations:

- *Governance Structure*. OCIE implemented a new governance structure, which now includes senior leaders from the Regional Offices, who manage both the Enforcement and Examinations programs in each Regional Office. The redesigned governance structure is intended to improve the lines of communication and accountability.

- *Specialization.* OCIE has hired senior specialized examiners with diverse skill sets to expand its knowledge base and improve its ability to assess risk, conduct examinations, detect and investigate wrongdoing, and focus its priorities. Additionally, OCIE has created five new specialist working groups that will be centers of excellence in critical areas and will help build examiner knowledge base, train examiners, develop exam modules, and focus risk-based exam strategies.

- *Conducting Risk-Based Examinations.* OCIE continues to refine its techniques to identify the areas of highest risk, and to deploy examiners against these risks, in order to improve compliance, prevent fraud, monitor

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1 The effectiveness of OCIE's examination program has been the subject of recent reports by the Commission's Inspector General ("IG") and the General Accountability Office ("GAO"). See, e.g., GAO Report, Steps Being Taken to Make Exams More Risk-Based (Aug. 2007); IG Report, Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Exams (Nov. 19, 2009); IG Report: Review and Analysis of OCIE Examinations of Bernard L. Madoff Investor Securities, LLC (Sept. 29, 2009).

2 The Section 914 Study and Commissioner Walter Statement, supra note 3 in Section II.A of the Study, contains additional information about OCIE's processes and resources.

risk and inform policy-making. In addition, OCIE works closely with the Division of Risk, Strategy, and Financial Innovation to enhance its risk assessment analytics and modeling, and coordinates several risk-based initiatives with the Division of Enforcement.

- *Coordinating Broker-Dealer and Investment Adviser Examinations.* OCIE has instituted several measures to coordinate broker-dealer and investment adviser examinations, including opportunities for examiners to cross-train.

To maintain an effective deterrent presence, the examination program needs to be adequately staffed to address increasingly complex financial products and transactions and the enormous size of the markets. The following additional transformations to the national exam program should further the program's effectiveness:

- establishing a new "open architecture" structure for staffing exams that will enable management to reach across disciplines and specialties to better match the skills of examination teams to the business models and risk areas of registrants;

- redesigning OCIE's exam team structure to redeploy the expertise and experience of managers from office administration to on-site exams in the field;

- staffing the newly created specialization working groups described above;

- creating an environment for open, candid communication and personal accountability for quality, in order to build on OCIE's core strengths;

- placing continuous, focused attention on technology, which is essential to a healthy examination program; and

- developing and testing standardized examination tools across the national exam program.

B. Examinations of Investment Advisers and Broker-Dealers

Investment Advisers

The Commission, through OCIE staff located in headquarters and 11 Regional Offices, examines Commission-registered investment advisers' books, records and activities. Staff examinations are designed to: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform regulatory policy. Consistent with these objectives, the results of OCIE's examinations are utilized by various offices and divisions within the Commission. For example, OCIE exam information may: inform rule-making initiatives

undertaken by the Division of Investment Management;[3] assist the Division of Risk, Strategy and Financial Innovation to identify and monitor risks; and identify misconduct to be pursued by the Division of Enforcement.

OCIE's investment adviser examination program utilizes a risk-based process, identifying higher risk Commission-registered investment advisers for examination consideration and focusing examination resources on certain higher risk activities at selected investment advisers. OCIE's risk-based approach to identifying examination candidates is an evolving process that is constantly refined as OCIE obtains information about registered investment advisers. Typically, higher risk investment advisers are identified based on: (1) information contained in regulatory filings; (2) assessments made during past examinations; and/or (3) other criteria and available information (including, for example, news/media coverage, localized knowledge of advisers from examination staff and tips, complaints or referrals).

OCIE generally conducts three types of examinations: (1) examinations of higher-risk investment advisers;[4] (2) cause examinations resulting from tips, complaints and referrals; and (3) special purpose reviews such as risk-targeted examination sweeps and risk assessment reviews. Risk-targeted examination sweeps are generally limited in scope and focus on specific areas of concern within the financial services industry and examine a broad sample of regulated entities regarding those areas.[5]

OCIE also has a role in examining the operations of dual registrants and Commission-registered investment advisers that are affiliated with broker-dealers.[6] The broker-dealer operations of these firms are examined primarily by FINRA, although OCIE also, but less frequently, examines broker-dealer operations of these firms. FINRA does not, however, have express statutory authority to enforce compliance with the Advisers Act by dual registrants or investment advisers affiliated with a broker-dealer. Therefore, the advisory operations of these Commission-registered firms are examined exclusively by OCIE according to the process described above.

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3 For example, OCIE conducted examinations regarding compliance with Advisers Act Rule 206(3)-3T. The staff's observations are discussed in this proposing release (See Advisers Act Release No. 3118 (December 1, 2010)).

4 Examiners typically will focus on the following high-risk areas: conflicts of interest; portfolio management; valuation; performance, advertising; and asset verification.

5 Similarly, risk assessment reviews are limited scope examinations of an investment adviser's general business activities and a targeted set of the adviser's books and records that help OCIE better assess the risk profile of an investment adviser.

6 While dual registrants comprise a small percentage of Commission-registered investment advisers, a significant number of these firms, including many larger Commission-registered investment advisers, have an affiliated broker-dealer. According to data from the IARD, as of October 1, 2010, there were 611 dual registrants and 2,636 Commission-registered investment advisers that had an affiliated broker-dealer. That represents 5% and 22% of all Commission-registered investment advisers, respectively.

Examination Data

The number and frequency of examinations of Commission-registered investment advisers is a function of factors, including the number of Commission-registered investment advisers and the number of OCIE staff.[7] As the number of Commission-registered investment advisers has increased and the number of OCIE staff has decreased over the past six years, there has been a decrease in the number and frequency of examinations of Commission-registered investment advisers.

The number of Commission-registered investment advisers has grown significantly over the past six years. Between October 1, 2004 and September 30, 2010, the number of Commission-registered investment advisers increased 38.5%, from 8,581 advisers to 11,888 advisers.[8] That represents an average annual growth rate of 5.7%. The assets managed by Commission-registered investment advisers have grown even faster than the number of Commission-registered investment advisers. Over the past six years, assets managed by these advisers grew 58.9%, from $24.1 trillion to $38.3 trillion. This represents an average annual growth rate of 9.1%.

The growth of the investment advisory industry over the past six years has not been matched by a corresponding growth in Commission resources committed to examining Commission-registered investment advisers, but rather, there has been a decline in Commission resources. Specifically, between October 1, 2004 and September 30, 2010, the number of OCIE staff dedicated[9] to examining Commission-registered investment advisers decreased from 3.6%, from 477 staff to 460 staff, falling as low as 425 staff at certain points during the period September 30, 2007 to September 30, 2008.[10]

Other relevant metrics highlight the growth of Commission-registered investment advisers relative to the resources committed to examining them. For example, the ratio of the number of Commission-registered investment advisers to the number of OCIE staff

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[7] See Section 914 Study and Commissioner Walter Statement, supra note 3 in Section II.A of the Study, for more information about OCIE's examinations of investment advisers.

[8] All statistics presented in the Study concerning the number of Commission-registered investment advisers and their assets under management are from the IARD.

[9] Unless stated otherwise, all references to OCIE staff in the Study are to staff who are dedicated to the examination of both registered investment advisers and registered investment companies. OCIE does not have staff who solely are dedicated to examining registered investment advisers. OCIE staff include examiners, accountants, supervisors, attorneys, information technology staff, training staff and support staff. All references to a number of staff include adjustments for part-time employees (for example, a part-time employee that works 20 hours per week counts as 0.5 staff).

[10] Based on data from the Commission's internal reporting systems. Unless stated otherwise, all data concerning the number and frequency of investment adviser examinations and the number of OCIE staff are based on data from the Commission's internal reporting systems.

committed to examining such firms, which is a proxy for the relative changes in the resources available to examine investment advisers, increased 43.3% over the past six years, from 18.0 to 25.8.[11] Viewed based on assets managed, rather than based on the number of Commission-registered investment advisers, the ratio increased 65% over that period, from $50.6 billion to $83.2 billion per examiner.

As the number of Commission-registered investment advisers and the assets managed by them have increased and the number of OCIE staff committed to examining Commission-registered investment advisers has decreased over the past six years, the number of examinations of Commission-registered investment advisers has decreased. The number of examinations of Commission-registered investment advisers conducted each year between 2004 and 2010 decreased 29.8%, from 1,543 examinations in 2004 to 1,083 examinations in 2010.

The table below shows the number of Commission-registered investment advisers examinations completed by the Commission since 2004.

Year	Investment Adviser Examinations[12]
2010	1,083
2009	1,244
2008	1,521
2007	1,379
2006	1,346
2005	1,530
2004	1,543

The percentage of Commission-registered investment advisers examined each year has also decreased over the past six years. While 18% of Commission-registered investment advisers were examined in 2004, only 9% of Commission-registered investment advisers were examined in 2010.[13] At the rate that Commission-registered investment advisers were examined in 2010, the average registered adviser could expect to be examined approximately once every 11 years, compared to approximately once every six years in 2004.[14] The decrease in both the number and frequency of

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[11] An increase in the ratios means that there are proportionately fewer resources committed to examining Commission-registered investment advisers.

[12] Information is reported by fiscal year (October 1 – September 30).

[13] With respect to the intervening years, 17% of Commission-registered investment advisers were examined in 2005, 14% of Commission-registered investment advisers were examined in 2006, 13% of Commission-registered investment advisers were examined in 2007, 13% of Commission-registered investment advisers were examined in 2008 and 11% of Commission-registered investment advisers were examined in 2009.

[14] Currently, Commission-registered investment advisers are not examined on a cyclical basis.

examinations is attributable, in part, to the growth in the number of Commission-registered investment advisers and the decline in the number of OCIE staff.

Examination Outcomes

An examination typically has one of three possible outcomes, which are not mutually exclusive. The outcomes are: (1) issue a letter to the registrant indicating that no deficiencies were identified; (2) issue a deficiency letter to the registrant describing the deficiencies and requesting the registrant to implement appropriate corrective actions, and submitting a written response describing the actions; or (3) refer the deficiencies to Enforcement, another regional office, or other regulator (e.g., a state regulatory agency or an SRO).

For any given year, the vast majority of examinations conclude with a deficiency letter which summarizes OCIE staff's findings and requests corrective action. In most cases, Commission-registered investment advisers will voluntarily correct the issues the noted by OCIE staff. This approach encourages compliance without costly and protracted enforcement action. Enforcement referrals allow examination staff to refer egregious violations of federal securities laws so the Commission can take action to prevent investors from being harmed.

Broker-Dealers

A broker-dealer that does business with the public is primarily overseen by the Commission and by FINRA. The Commission and the SROs conduct examinations of broker-dealers to ensure compliance with federal securities laws and with standards of integrity, competence, and financial soundness, and may discipline broker-dealers and associated persons that fail to comply with applicable requirements.

SRO Examination

The SROs examine broker-dealers for compliance with the federal securities laws and their own rules by their members and the associated persons of their members.[15] The SROs examine every broker-dealer on cycles varying from annually to once every four years, depending on the type of firm. The disciplinary procedures employed by the SROs are subject to Commission oversight under the Exchange Act. If a broker-dealer is a member of more than one SRO, the Commission designates one SRO to examine the

[15] The authority of SROs to examine broker-dealers and their associated persons is derived from several sources. For example, under Exchange Act Section 19(g)(1), every SRO shall enforce compliance with the Exchange Act, Exchange Act rules, and its own rules by its members and associated persons of members, unless the SEC relieves it of the obligation. The Commission construes Section 19(g)(1) as requiring SROs to "examine for" compliance. See, e.g., Exchange Act Release No. 59218 (Jan. 8, 2009) ("Section 19(g)(1) . . . requires every self-regulatory organization . . . to examine for, and enforce compliance by, its members and persons associated with its members . . . .").

broker-dealer for compliance with financial responsibility rules, thereby eliminating duplication.[16]

FINRA is the designated examining authority for all securities firms doing business with the public, and has primary responsibility for the regulatory oversight of a broker-dealer's activity.[17] FINRA oversees approximately 4,600 brokerage firms, approximately 163,000 branch offices and over 630,000 registered securities representatives.[18] In light of the extent of FINRA's oversight of broker-dealers, particularly with respect to retail customers, this Study focuses specifically on FINRA's regulatory, examination and enforcement resources.

- Overview of FINRA Jurisdiction

Generally, FINRA's authority is limited to enforcing compliance by its members and their associated persons with the Exchange Act and rules thereunder, MSRB rules, and FINRA rules.[19] In addition, Exchange Act Section 15A(b)(6) precludes the rules of the association from being designed to regulate matters not related to the purposes of Exchange Act or the administration of the association; Section 19(b)(2) of the Exchange Act requires each of FINRA's rule and rule amendments to be approved by the Commission, unless the rule change is effective upon filing, based on a finding that the proposed rule change is consistent with the requirements of the Exchange Act.[20]

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16 See Exchange Act Section 17(d)(1)(A) and Rule 17d-1 thereunder. In addition, the Commission has the authority under Exchange Act Section 17(d)(1)(B), and Rule 17d-2 thereunder, to allocate among SROs the authority to adopt rules with respect to matters as to which, in the absence of such allocation, such SROs share authority under the Exchange Act.

The Commodity Futures Modernization Act contains provisions to facilitate coordination of examinations of market participants involved with security futures products.

17 See FINRA Letter, supra note 471 in Section IV of the Study.

18 FINRA Statistics, available at http://www.finra.org/Newsroom/Statistics/. As of September 30, 2010, there were 636,529 registered representatives overseen by FINRA. See FINRA January Letter, supra note 10. The number of FINRA member firms has decreased by 10.4% since 2005, from 5,111 to 4,578 in 2010. The number or registered representatives has decreased by 3.8% since 2005, from 655,832 to 630,692 in 2010. FINRA Statistics, available at http://www.finra.org/Newsroom/Statistics/, and NASD 2005 Year in Review at 7, available at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p016705.pdf .

19 See Exchange Act Sections 15A(b)(2) and 19(g)(1).

20 Exchange Act Section 19(b) requires the Commission to review and approve most SRO rules before they can be put into effect. Proposed rules are published to give the public notice and an opportunity to comment. Most SRO rule filings are handled by the Division of Trading and Markets pursuant to delegated authority. See 17 CFR 200.30-3(a)(12) (delegating authority to the Director of the Division of Trading and Markets) "to publish notices of proposed rule changes filed by self-regulatory organizations and to approve such rule changes" pursuant to Exchange Act Rule 19b-4).

FINRA does not, however, have express statutory authority to enforce compliance with the Advisers Act by the investment adviser operations of the dual registrants or investment adviser affiliates of broker-dealers.[21] FINRA has stated that it "is not authorized to enforce compliance with the Investment Advisers Act" and that such authority "is granted solely to the SEC and to the states."[22]

Exchange Act Section 19(b)(3)(A) provides that a proposed rule change shall take effect upon filing with the Commission if it is designated by the SRO as: (1) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO; (2) establishing or changing a due, fee or other charge imposed by the SRO on any person, whether or not the person is a member of the SRO; or (3) concerned solely with the administration of the SRO or other matters which the Commission has specified by rule as being outside the requirements of Section 19b(2). Nevertheless, even if an SRO rule is effective upon filing, the Commission summarily may temporarily suspend the change in the rules and institute proceedings under Section 19(b)(2)(B) to determine whether the proposed rule should be approved or disapproved, if the Commission believes such action is necessary or appropriate in the public interest or otherwise in furtherance of the purposes of the Exchange Act.

21 Exchange Act Section 19(g) directs an SRO to enforce compliance with its own rules, the Exchange Act, and the rules and regulations thereunder. See also Section 914 Study and Commissioner Walter Statement, supra note 3 in Section II.A of the Study.

22 See Testimony by Stephen I. Luparello, Interim CEO, FINRA, Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, Feb.4, 2009 (noting that "Congress limited our authority to the enforcement of the Securities Exchange Act of 1934, the rules of the Municipal Securities Rulemaking Board and FINRA rules. Under our fragmented system, broker-dealers are regulated under the Securities Exchange Act and investment advisers are regulated under the Investment Advisers Act of 1940."). See also Charles A. Bowsher, et al., Report of the 2009 Special Review Committee on FINRA's Examination Program In Light of the Stanford and Madoff Schemes (Sept. 2009) ("2009 Special Review Committee Report"), available at: http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.. at 65 ("FINRA lacks jurisdiction to regulate a significant percentage of the financial institutions, products and transactions in our country. Of particular relevance for purposes of this review, FINRA lacks the authority to inspect for or enforce compliance with the Investment Advisers Act.").

Among other requirements, Exchange Act Section 15A(b)(6) requires the rules of an association be designed to promote just and equitable principles of trade. As noted above, the Commission has held that FINRA's authority under Rule 2010 relating to "just and equitable principles of trade" permits FINRA to sanction member firms and associated persons for a variety of unlawful or unethical activities, including those that do not implicate "securities." See supra Section II.B of the Study under "Fair Dealing."

- FINRA Examination of Broker-Dealers

FINRA has examination staff of more than 1,000 employees[23] to oversee and examine its over 4,500 member firms. [24]

Year	FINRA Member Firms [25]
2010	4,578
2009	4,720
2008	4,895
2007	5,005

FINRA conducts onsite "cycle" or "routine" exams on cycles ranging from every one, two, three or four years, depending on FINRA's annual risk assessment of the member firm.[26] The risk assessment allows FINRA to concentrate its resources on the firms it believes pose the most significant harm to investors, and considers a number of factors, including: a firm's business activities, methods of operation, types of products offered, compliance profile and financial condition.[27] Firms that are determined to be of greatest risk are examined every year.[28] FINRA also conducts initial examinations of its new member broker dealers within six months of registration with the SEC, as required by SEC Rule 15b2-2. FINRA assigns a separate risk-based cycle to member firms for sales practice reviews and for financial operations reviews, with the majority of firms on

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23 FINRA Letter, supra note 471 in Section IV of the Study. FINRA's examination staffing level has remained consistent between 2007 and 2010: 1,097 employees in 2007; 1,067 employees in 2008; 1,045.5 employees in 2009; and 1,059 employees in 2010. See letter from Helen Moore, Vice President – Regulatory Operations, FINRA, dated October 20, 2010 ("FINRA October Letter").

24 Specifically, there were 5,005 member firms registered with FINRA in 2007, 4,895 in 2008, 4,720 in 2009 and 4,578 in 2010. See FINRA Statistics, available at: http://www.finra.org/Newsroom/Statistics/index.htm (last visited Jan. 13, 2011).

25 See FINRA Statistics, available at: http://www.finra.org/Newsroom/Statistics/index.htm (last visited Jan. 13, 2011).

26 2009 Special Review Committee Report, supra note 22 at 10. See also FINRA Letter, supra note 471 in Section IV of the Study. FINRA added the three year exam cycle to its existing one, two and four year cycles in 2010. See FINRA October Letter, supra note 23.

27 FINRA Letter, supra note 471 in Section IV of the Study; 2009 Special Review Committee Report, supra note 22, at 10.

28 2009 Special Review Committee Report, supra note 22 at 10.

a four year cycle for each review.[29] In 2008, 2009 and 2010, FINRA's sales practice review cycles included the following number of member firms:[30]

Year	1 Year Cycle	2 Year Cycle	3 Year Cycle	4 Year Cycle
2010	167	1,315	835	2,351
2009	103	1,921		3,264
	91	840		4,122

Also between 2008 and 2010, FINRA's financial operation review cycles included the following number of member firms:[31]

Year	1 Year Cycle	2 Year Cycle	3 Year Cycle	4 Year Cycle
2010	285	1,263		2,294
	296	1,601		3,478
2008	207	807		4,039

[29] FINRA October Letter, supra note 23; E-mail from Glenn Verdi, Counsel – Regulatory Operations, FINRA (Jan. 11, 2011, EDT 15:47) ("FINRA January E-mail").

[30] See id.

[31] Id.

On average, FINRA conducts 2,100 cycle exams each year.[32] Specifically, FINRA conducted 2,276 cycle exams in 2008, 2,351 in 2009 and 2,151 in 2010.[33] FINRA exam staff completed cycle exams in an average 125 days in 2008, 145 days in 2009 and 174 days in 2010.[34] The cycle exams completed between 2008 and October 20, 2010, resulted in the following number of informal and formal disciplinary actions, which range from deficiency letters to enforcement actions and can result in censure and fines as well as suspension or expulsion from FINRA membership or association:[35]

Year	Cycle Exams Resulting in Informal Disciplinary Action	Cycle Exams Resulting in Formal Disciplinary Action
2010	1,064	
	1,827	130
2008	1,726	136

Of the cycle exams that resulted in formal disciplinary actions between 2008 and October 20, 2010, the following sanctions were levied against the member firm and/or associated person:[36]

Year	Firms Expelled	Suspensions	Individuals Barred	Fines
2010	2	16	8	
	1	26	8	129
2008	0	28	4	163

FINRA also conducts "cause" or "targeted" examinations based on customer complaints, anonymous tips, and referrals from the Commission, market surveillance staff and arbitrations.[37] FINRA conducts approximately 5,000 cause exams each year.[38]

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32 2009 Special Review Committee Report, supra note 22, at 10.

33 See FINRA October Letter, supra note 23; FINRA January E-mail, supra note 29. The number of firms for which a cycle exam was completed in 2008, 2009 and 2010 (through October 20, 2010), represented 46%, 50% and 26% of FINRA's member firm population, respectively. Id.

34 Id. The 2010 figure represents that average number of days FINRA staff took to complete cycle exams in the twelve months ending August 31, 2010. Id.

35 Id. Informal disciplinary action includes Cautionary Actions and Compliance Conferences. Id. Formal disciplinary action includes Letters of Acceptance, Waiver and Consent, Formal Complaints, Minor Rule Violations, and Orders Accepting Offers of Settlement and Non-Summary Proceedings. Id.

36 Id.

37 FINRA Letter, supra note 471 in Section IV of the Study; 2009 Special Review Committee Report, supra note 22, at 10.

In 2008, 2009 and 2010, FINRA completed 5,656, 7,002 and 6,387 cause exams, respectively.[39] FINRA exam staff completed cause exams in an average 175 days in 2008, 198 days in 2009 and 231 days in 2010.[40] The cause exams completed between 2008 and October 20, 2010, resulted in the following number of informal and formal disciplinary actions:[41]

Year	Cause Exams Resulting in Informal Disciplinary Action	Cause Exams Resulting in Formal Disciplinary Action
2010	615	425
2009	1,228	736
2008	1,271	677

Of the cause exams that resulted in formal disciplinary actions between 2008 and October 20, 2010, the following sanctions were levied against the member firm and/or associated person:[42]

Year	Firms Expelled	Suspensions	Individuals Barred	Fines
2010	1	211	159	176
2009	3	305	273	320
2008	2	296	289	288

As a result of all cycle and cause exams completed between 2008 and 2010 that resulted in formal disciplinary action, FINRA billed the following total amount of fines and ordered the following total amount of restitution in each respective year:[43]

	2010	2009	2008
Fines	$33,282,834	$49,650,540	$25,819,625
Restitution	$3,422,298	$8,347,493	$3,646,715

As noted above, FINRA states that it recently enhanced its examination programs with respect to investment adviser activity at member firms to the extent FINRA has

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38 2009 Special Review Committee Report, supra note 16.

39 See FINRA October Letter, supra note 23, and FINRA January E-mail, supra note 29.

40 Id. The 2010 figure represents that average number of days FINRA staff took to complete cause exams in the twelve months ending August 31, 2010. Id.

41 Id.

42 Id.

43 Id. The 2010 figure represents that amount of fines billed and restitution ordered in the twelve month period ending August 31, 2010. Id.

jurisdiction.[44] Such enhancements include identifying indications of problematic behavior with the opening of investment advisory accounts at broker-dealers and verifying compliance with custody requirements when firms have a higher level of control over customer assets, such as when acting as both adviser and broker to customers.[45]

In addition, FINRA recently made several other enhancements to its examination program.[46] Specifically, FINRA created several new examination elements corresponding to high-risk areas identified at dual registrants, including the following: Ownership and Affiliate Background and Apparent Conflicts of Interest, which expands review and verification regarding broker-dealer ownership, affiliate relationships and conflicts of interest; Feeder Funds, which examines the relationships between broker-dealers and their affiliates with feeder funds; and Financial Statement and Filings Analysis, which examines statements and filings for potentially fraudulent activity.[47] FINRA is also reviewing its rules to identify changes that could assist in FINRA detecting potentially fraudulent activity and to identify possible enhancements to the registration process.[48] Furthermore, FINRA expanded its regulatory review of arbitration matters to include not only customer-related statements of claim, but also employer-employee statements of claim.[49] Finally, FINRA created the Office of the Whistleblower ("OWB"), which encourages reporting of information about potentially illegal or unethical activity and expedites review of those high-risk tips.[50] From its inception until August 17, 2009, FINRA's OWB received over 100 tips, which have resulted in fifteen referrals to other regulators as well as several on-going FINRA investigations.[51]

Commission Examination of Broker-Dealers

While the Commission staff examines broker-dealers, particularly when a risk has been identified (as described below) or when evaluating the examination work of an SRO, the Commission does not examine broker-dealers on a routine basis.

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44 FINRA Letter, supra note 471 in Section IV of the Study.

45 FINRA Letter, supra note 471 in Section IV of the Study.

46 See Testimony of Daniel M. Sibears, Executive Vice President, Member Regulation, FINRA, available at: http://www.finra.org/Newsroom/Speeches/Sibears/P119812 (posting testimony before the Senate Committee on Banking, Housing and Urban Affairs on August 17, 2009).

47 Id.

48 Id.

49 Id. FINRA's regulatory review of arbitration matters also now includes review of any claims filed after the original statement of claim, including amended claims and claims filed by other parties involved in the matter. Id.

50 Id.

51 Id. Four of the matters referred to the Commission have resulted in publicly disclosed regulatory actions. Id.

The Commission generally focuses its limited resources in the broker-dealer examination program on firms with the greatest potential for significant financial risk and risk of material violations of securities laws. The leading type of examination in recent years is the cause examination, primarily based on a tip or complaint. In addition to cause examinations, Commission examiners also conduct special risk-focused examinations that may involve several firms reviewing the same focused risk area to determine if a compliance problem may be widespread or to identify trends in the securities industry. For example, some recent so called sweep examinations have evaluated options order routing and execution; sales of variable insurance products; and securities firms providing "free lunch" sales seminars to senior investors. The Commission examination program currently has a cyclical examination of the largest 30 broker-dealers during which a more comprehensive review of risk management internal controls is conducted; this includes reviews of market, credit, operational, and legal and compliance risks, as well as funding and liquidity and asset verification. Given the growth in the volume of securities transactions, internationalization of the securities markets, the introduction of new financial products, and obligations regarding anti-money laundering compliance, a firm's system of internal controls and risk management has taken on an even greater level of importance. These examinations include review and testing of a firm's internal controls and risk management policies, as well as its compliance procedures.

Finally, the Commission examination program conducts a limited number of examinations, known as oversight examinations, which are intended to evaluate whether the SROs are effectively monitoring, regulating, and disciplining their members. In general, the examinations may be focused on identified priorities or high risk areas. Some of these may include: financial and operational risks; new or complex products (e.g., variable annuities, structured products, life settlements, microcap securities); controls at recently merged/acquired firms; risk management issues (mismatched durations, valuation of complex securities, stress testing, risk limits); protection of customer assets; fraud and insider trading.

- Examination Data

The number and frequency of examinations of Commission-registered broker-dealers is a function of both the number of Commission-registered broker-dealers and the number of OCIE staff. The number of Commission-registered broker-dealers increased slightly from 2007 to 2008 but since then has decreased slightly from 2008 to 2010. The following chart shows this increase and subsequent decline.

Year	Broker Dealer Population[52]
2010	5,357
2009	5,559
2008	5,748
2007	5,095

[52] The broker-dealer population numbers were aggregated from Form BD.

The examination staff population has stayed relatively constant with the lowest number of staff being 365 in 2008 and the highest number of staff being 405 in 2006.

Year	Broker-Dealer Examination Staff
2010	380
2009	376
2008	365
2007	392
2006	405

Due to more and more complex examinations the number of examinations performed by the broker-dealer exam staff has decreased in recent years due to the need to review more complex issues, making the exams more lengthy and intricate. The decrease is also attributable to other changes in the Commission's examination program. For example, OCIE has devoted more resources to cause examinations and special risk-focused examinations. In addition, OCIE is performing additional procedures, such as enhanced asset verification to detect fraud based on misappropriation of investor assets, during examinations.

Year	Broker-Dealer Examinations[53]
2010	490
2009	662
2008	772
2007	675
2006	764

- Examination Outcomes

In general, most examinations conclude with the Commission exam staff sending a letter summarizing the staff's findings, including any deficiencies and weaknesses. Similar to the investment adviser examination program, the examination outcomes are: (1) issue a letter to the registrant indicating that no deficiencies were identified; (2) issue a deficiency letter to the registrant describing the deficiencies and requesting that the registrant implement appropriate corrective actions, and submitting a written response describing the actions; or (3) refer the deficiencies to Enforcement, another regional office, or other regulator (e.g., a state regulatory agency or an SRO). In recent years, approximately 94% of examinations conclude with a deficiency letter which summarizes OCIE staff's findings and requests corrective action. The broker-dealer will voluntarily

[53] Information is reported by fiscal year (October 1 – September 30). Statistics concerning the number of examinations of Commission-registered broker-dealers are from OCIE's internal examination tracking system.

correct the compliance problems detected by the Commission staff. This approach encourages compliance without costly and protracted enforcement action.

Commission Oversight of SROs

Under the Exchange Act, the Commission must evaluate whether the SROs require their members to comply with the federal securities laws and rules of the SROs. The Commission, through OCIE and the Division of Trading and Markets, inspects SROs' regulatory programs to evaluate whether the SROs are effectively monitoring for violations of SRO rules and the Exchange Act by broker-dealers and properly citing broker-dealers for violations.

In addition to the many inspections of the SRO regulatory programs that the Commission staff conducts each year, the Commission staff continually evaluates the quality of the SRO regulatory work through general assessments based on information required to be submitted by SROs, numerous meetings where information is presented in response to Commission staff inquiries, evaluation of SRO examinations through the oversight examinations, and other general oversight work.

Under Exchange Act Section 19(h), the Commission can bring an action against an SRO for failure to adequately regulate its members. For example, the Commission has used this authority to bring actions for failure to enforce compliance with the securities laws against, among others, the NYSE,[54] the American Stock Exchange,[55] the Boston Stock Exchange,[56] the National Stock Exchange,[57] and the Philadelphia Stock Exchange.[58] The Commission also has prepared reports pursuant to Exchange Act Section 21(a) regarding SROs.[59]

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54 See In the Matter of New York Stock Exchange, Inc., Exchange Act Release No. 51524 (Apr. 12, 2005).

55 See In the Matter of American Stock Exchange LLC, Exchange Act Release No. 55507 (Mar. 22, 2007).

56 See In the Matter of Boston Stock Exchange Inc. and James B. Crofwell, Exchange Act Release No. 56352 (Sept. 5, 2007).

57 See In the Matter In the Matter of National Stock Exchange and David Colker, Exchange Act Release No. 51714 (May 19, 2005).

58 See In the Matter of Philadelphia Stock Exchange, Inc., Exchange Act Release No. 53919 (June 1, 2006).

59 See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding The Nasdaq Stock Market, Inc., as Overseen By Its Parent, The National Association of Securities Dealers, Inc., Exchange Act Release No. 51163 (Feb. 9, 2005); In the Matter of National Association of Securities Dealers, Inc., Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and NASDAQ Market, Exchange Act Release No. 37542 (Aug. 8, 1996).

C. Commission Enforcement

The Commission is authorized to bring injunctive actions in federal district court against any person, including investment advisers and broker-dealers, for violation of the federal securities laws.[60] In an injunctive action, the Commission may seek disgorgement plus prejudgment interest, civil monetary penalties, penny stock bars, an accounting, and other remedial sanctions against individuals and entities that have violated or aided and abetted violations of the federal securities laws.

The Commission may also institute administrative proceedings against investment advisers, broker-dealers and their respective associated persons for violations of the federal securities laws. Under Advisers Act Sections 203(e) and 203(k) and Exchange Act Sections 15(b)(4) and 21C, the Commission may institute administrative proceedings to seek remedial sanctions against an investment adviser or a broker-dealer, respectively, based on an allegation that an entity has been found to have willfully violated, aided and abetted, or failed reasonably to supervise any person who violated, or aided and abetted, a violation of the federal securities laws.[61] The Commission may impose remedial sanctions such as censure, revocation of registration, suspension for 12 months or less or bar,[62] or placing limitations on the activities, functions, or operations of the broker-dealer or investment adviser. The Commission may also order the party to cease and desist from committing or causing federal securities law violations, and may impose orders for disgorgement plus prejudgment interest, accounting, and penalties.[63]

Criminal Prosecution

Under Advisers Act Section 217 and Exchange Act Section 21(d), the Commission is authorized to refer any matter to the Department of Justice, which

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60 See Advisers Act Section 209(d); Investment Company Act Section 42(d); Securities Act Section 20(b); Exchange Act Section 21(d).

61 Dodd-Frank Act Section 929O amended Section 20(e) to state that aiding and abetting violations encompass both knowing and reckless assistance ("any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided"). Dodd-Frank Act Section 929M added provisions to Securities Act Section 15 and Investment Company Act Section 48 that makes it a violation to aid and abet another person who violates a provision under the Securities Act ("any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this Act, or of any rule or regulation issued under this Act, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.")

62 The Commission may grant barred individuals a right to reapply to become an associated person after a period of time.

63 Pursuant to Securities Act Section 8A, the Commission also is authorized to institute administrative cease-and-desist proceedings against any person, including an investment adviser or a broker-dealer, for committing or causing violations of the Securities Act.

determines whether criminal prosecution would be appropriate. It is a criminal offense to willfully violate any provision of the Advisers Act, Securities Act or the Exchange Act, or to willfully make false statements in any application, report, or document filed with the Commission.[64] Under Exchange Act Section 32(a), a court may impose criminal penalties of up to $25 million on any non-natural person, such as a broker-dealer, that has been convicted of willfully violating any provision of the Exchange Act (other than Section 30A – the Foreign Corrupt Practices Act) or any rule thereunder. Advisers Act Section 217 provides that any person convicted of willfully violating the Advisers Act or any rule, regulation or order thereunder may be fined up to $10,000 and imprisoned for up to five years. Criminal actions against an adviser or a broker-dealer are prosecuted by the Department of Justice.

The Division of Enforcement

The Commission has broad statutory authority under the federal securities laws to investigate whether violations of the federal securities laws have occurred or are about to occur. Enforcement, the Commission's largest Division, assists in executing the Commission's law enforcement function by investigating potential securities law violations, by recommending that the Commission bring civil actions in federal court or institute administrative proceedings before an administrative law judge, and by prosecuting these cases on behalf of the Commission. As an adjunct to the Commission's civil enforcement authority, Enforcement works closely with criminal law enforcement agencies in the United States and around the world, who bring parallel or related criminal cases when appropriate. In FY2010, for example, prosecutors filed indictments, informations, or contempt actions in 139 Commission-related criminal cases.

Enforcement obtains evidence of possible violations of the federal securities laws from many sources, including Division surveillance, monitoring, and risk analysis, investor tips and complaints, other divisions and offices of the Commission (such as referrals from OCIE), the SROs and other securities industry sources, foreign authorities, and media reports.[65] In recent years, Enforcement has brought approximately 600 enforcement actions each year against individuals and entities accused of violating the federal securities laws. As shown in more detail in the chart below, the mix and types of actions vary from year to year, based upon, among other factors, market conditions, changes in financial instruments being used, and Commission or Division priorities. In general, violations involving broker-dealers could include: market manipulation; abusive sales practices, such as recommending unsuitable securities, churning, and unauthorized trading in customer accounts; misrepresentations; failures to perform due diligence prior to recommending securities; insider trading; compliance and internal controls violations; violations of various recordkeeping requirements; and failures reasonably to supervise representatives. Cases involving investment advisers could include: failures to disclose

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64 Advisers Act 203(e); Securities Act Section 24; Exchange Act Section 32(a).

65 For example, in fiscal year 2010, 21.9% of investigations came from internally-generated referrals or prospects.

conflicts of interest, misrepresentations, breaches of fiduciary duty, insider trading; valuation issues; compliance and internal controls violations; violations of various recordkeeping requirements; and failures reasonably to supervise. Typically, actions primarily involving broker-dealers represent 9% to 22% of total Enforcement actions brought each year, and actions primarily involving investment advisers represent 11% to 16% of total Enforcement actions brought each year, as shown more fully in the chart below.

Number of Enforcement Actions Filed By Primary Classification (with number of defendants and respondents noted parenthetically)[66]

FY	Total Actions	Broker-Dealer	Broker-dealer Percentage	Investment Adviser	Investment Adviser Percentage
2010	681 (1817)	70 (95)	10%	107 (221)	16%
2009	664 (1787)	109 (182)	16%	76 (227)	11%
2008	671 (1635)	60 (89)	9%	79 (161)	12%
2007	656 (1449)	89 (179)	14%	72 (135)	11%
2006	574 (1163)	75 (107)	13%	87 (161)	15%
2005	630 (1286)	94 (175)	15%	95 (159)	15%
2004	639 (1454)	141 (245)	22%	76 (138)	12%

Enforcement regularly obtains orders on behalf of the Commission in judicial and administrative proceedings requiring securities violators to disgorge ill-gotten gain and to pay civil penalties. The chart below shows the amount of disgorgement and civil penalties ordered over the past several years.

Money Ordered in All Commission Judicial and Administrative Proceedings

FY	Disgorgement	Penalties	Total
2010	$ 1.82 billion	$ 1.03 billion	$ 2.846 billion
2009	$ 2.09 billion	$ 345 million	$ 2.442 billion
2008	$ 774 million	$ 256 million	$ 1.03 billion
2007	$ 1.093 billion	$ 507 million	$ 1.6 billion
2006	$ 2.3 billion	$ 975 million	$ 3.275 billion
2005	$ 1.6 billion	$ 1.5 billion	$ 3.1 billion
2004	$ 1.9 billion	$ 1.2 billion	$ 3.1 billion

[66] Each action is included in only one category, even though many actions involve multiple allegations and may fall under more than one category. For example, there may be actions that are not primarily classified as "Broker-Dealer" or "Investment Adviser" that may include broker-dealer or investment adviser misconduct.

Staffing and Recent Developments

During the past year and a half, the Division of Enforcement has undergone a dramatic reorganization and restructuring. The Division undertook a top-to-bottom self-assessment of its operations and processes and as a result, implemented a series of sweeping reforms designed to optimize the use of resources, gather and utilize expertise across the Division and the Commission, bring cases more swiftly and more efficiently, and increase strategic analysis and proactive investigations.[67]

As of the end of fiscal year 2010, the Division of Enforcement had 1,201 individuals, including 804 attorneys, 117 accountants, 85 paralegals, and 165 support staff, all led by 30 senior leaders. Following is a summary of Enforcement full time employees ("FTEs") over the past several years.

Fiscal Year	**Total Enforcement Staffing (FTEs)**
2009	1,179
2008	1,148
2007	1,111
2006	1,157
2005	1,232
2004	1,144

To maintain an effective deterrent presence, the enforcement program needs to be adequately staffed to address increasingly complex financial products and transactions and the enormous size of the markets. In addition, the enforcement program needs to be able to take prompt action to halt violations and try to recover funds. Additional positions will complement the enforcement program's current reorganization efforts by:

- expanding and focusing the investigations function, so Enforcement can strengthen its efforts to identify areas appropriate for enhanced investigative efforts;
- staffing the newly created Office of Market Intelligence;
- strengthening the litigation function in order to succeed in an increased number of trials;

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67 See Robert Khuzami, Director of the Division of Enforcement, U.S. Securities and Exchange Commission, Testimony Concerning Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act Before the United States Senate Committee on the Judiciary (Sept. 22, 2010), for more information on the Division of Enforcement's recent efforts.

- increasing staffing in the Office of Collections and Distributions, which is responsible for collecting penalties and disgorgements and returning funds to harmed investors whenever possible; and

- expanding staff in the Division's information technology group.

D. FINRA Enforcement

FINRA has the authority to bring a disciplinary action against any member firm or associated person for failure to comply with the federal securities laws, the rules of the MSRB, and FINRA Rules.[68] FINRA is authorized[69] to impose sanctions on a member or person associated with a member for violations of such rules and regulations, including: cautionary actions (for minor offenses), censure, fine, suspension for a definite period, or a period contingent on the performance of a particular act, expulsion of a member or suspension or bar of a person associated with a member, temporary or permanent cease-and-desist order against a member or a person associated with a member, and any other fitting sanction.[70] FINRA often requires firms to provide restitution to harmed investors and imposes other conditions on a broker-dealer to prevent repeated wrongdoing.[71] FINRA disciplinary actions are subject to review by the Commission.

In 2009, FINRA brought over 993 disciplinary actions.[72] FINRA levied fines against firms and individuals totaling nearly $50 million, and ordered firms and individuals to return more than $8.2 million in restitution to investors.[73] FINRA also expelled 20 firms, barred 383 individuals from the industry, and suspended 363 others.[74]

This data is consistent with disciplinary actions taken by FINRA (and the NASD and NYSE) between 2004 and 2008. For each year during this period, disciplinary actions by these entities on average resulted in the collection of approximately $97.4 million in fines against firms and individuals, and restitution for investors of approximately $105 million.[75] These included actions related to the sale of auction rate securities that resulted in over $28 million in fines and over $1 billion returned to

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68 See, e.g., FINRA Bylaws of the Corporation, Article XIII, Section 1.

69 See, e.g., FINRA Bylaws of the Corporation, Article XIII, Section 1; FINRA Rule 8310.

70 See, e.g., FINRA Letter, supra note 471 in Section IV of the Study.

71 FINRA Letter, supra note 471 in Section IV of the Study.

72 FINRA Letter, supra note 471 in Section IV of the Study.

73 FINRA Letter, supra note 471 in Section IV of the Study.

74 FINRA Letter, supra note 471 in Section IV of the Study.

75 2009 Special Review Committee Report, supra note 22, at 9.

investors.[76] Additionally, in each of these years, an average of 21 firms were expelled, 443 registered representatives barred, and 396 others suspended.[77] FINRA also receives approximately 25,000 complaints, tips and similar items each year.[78]

If the SROs find evidence of violations outside of their jurisdiction, they make referrals to the Commission or another appropriate regulator. SRO disciplinary procedures are subject to Commission oversight.

II. State Regulatory, Examination and Enforcement Resources

As previously discussed above, the states regulate the activities of investment advisers and broker-dealers in a number of ways. The following section discusses states' examination and enforcement programs relating to investment advisers and broker-dealers. The information and data in this section are derived from the analysis provided by NASAA regarding the effectiveness of state regulatory resources and examinations.[79] NASAA compiled its report through questionnaires and interviews prepared and conducted from August 30, 2010 to September 7, 2010.[80] The data in the NASAA Report is reported in the aggregate and not on a state-by-state basis.

A. Overview of State Examinations

The states are responsible for examining state-registered investment advisers and investment adviser representatives. For broker-dealer examinations, NASAA reported that the states collaborate with the Commission and FINRA to help ensure that registrants are regularly examined for both basic compliance and antifraud purposes.[81] NASAA reported that the examination process at the state level typically begins before an entity becomes a registrant.[82] In particular, NASAA stated that state securities regulators review information submitted by applicants to determine whether the applicant satisfies the state's registration requirements. This examination includes an evaluation of the

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76 See 2009 Special Review Committee Report, supra note 22, at 9.

77 2009 Special Review Committee Report, supra note 22, at 9.

78 2009 Special Review Committee Report, supra note 22, at 9.

79 See NASAA Report, supra note 405 in Section II.C.1 of the Study.

80 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 2.

81 NASAA Report, supra note 405 in Section II.C.1 of the Study at 3. However, NASAA has expressed concerns that state exam collaboration and coordination with FINRA has not been as effective as desired, given FINRA's concerns that their actions as a private entity may be attributed to the states pursuant to the "State Actor Doctrine." See NASAA Report, supra note 405 in Section II.C.1 of the Study. For a discussion of the state actor doctrine, see Division of Enforcement, U.S. Securities Exchange Commission, Enforcement Manual at 49 (Jan. 2010), available at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

82 Id.

applicant's history as disclosed on the Forms BD and ADV and the applicant's performance on competency exams written by the states.[83] NASAA found that the states also review and monitor registrant activity to assess whether the firms remain qualified to do business in their state.[84]

NASAA reported that states monitor ongoing compliance in a variety of ways including, but not limited to, post-registration reviews, annual questionnaires, and both on- and off-site examinations.[85] NASAA found that for investment advisers, state routine exams commonly occurred within a three-to-five year examination cycle.[86] NASAA reported that the frequency of exams of broker-dealer were similarly frequent, but given complementary examination programs at the Commission and FINRA, state examinations in this area are often "for-cause" or address special circumstances.[87]

NASAA reported that nationwide, state securities regulators employ a total licensing and examination staff of over 400 professionals, including examiners, auditors, accountants, attorneys and support staff.[88] While approximately 25% of states have staff members who are cross-trained to perform both pre-licensing reviews and post-registration examinations, the states reported to NASAA that 120 staff members are assigned primarily to application and pre-license review and analysis.[89] The states also reported that they employ an additional 230 field examiners and auditors dedicated to the assessment of compliance at investment advisers and broker-dealers, and reported another 60 administrative assistants, support staff, financial analysts, staff economists and attorneys who support both the registration and examination functions.[90]

B. Investment Adviser Examinations

As previously discussed in Section II.B.1, most small advisers (those with fewer than $25 million under management (raised to $100 million under management as of July 21, 2011)) are prohibited from registering with the Commission and are registered and

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83 Id.

84 Id.

85 Id.

86 Id.

87 Id. An examination that is precipitated by an investor complaint, an industry tip, peer regulator referral, or other method is most commonly referred to by the states as a "for-cause" examination. NASAA Report, supra note 405 in Section II.C.1 of the Study at 9.

88 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 11.

89 Id.

90 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 12.

regulated by state regulators.[91] NASAA reported that the methods utilized by the states to conduct examinations ranged from standard annual questionnaires to formal court-petitioned inspections.[92] NASAA found that the number of registration and examination professionals working for state regulators produced a ratio of one full-time licensing/exam staff member for approximately every 37 state-registered investment advisers.[93] NASAA also found that virtually all states (94%) conduct investment adviser examinations on-site at the investment adviser's principal place of business on a "routine" or non-cause basis. These examinations are often initiated within the first two years of a firm's registration. NASAA reported that follow-up examinations are conducted thereafter on a frequent basis to reinforce strong compliance practices and are designed to prevent, rather than react to, fraud and abuse.[94]

The table below shows the number of on-site investment adviser examinations completed by the states since 2006.

Year	Investment Adviser Examinations[95]
2010	2,463 (YTD – August 2010)
2009	2,378
2008	2,389
2007	2,136
2006	2,054

NASAA reported that these annual investment adviser examination numbers were consistent with the states' average examination cycle of three to five years.[96] NASAA noted in some of the most populous states, states demonstrate a relatively high number of examinations. In particular, one state reported 257 examinations of investment advisers in 2009, representing 41% of that state's registered investment adviser firms.[97] This same state reported examinations of nearly 50% of all state-registered investment adviser firms every year from 2006 to 2008.[98] Another state reported 1,014 examinations in five

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91 See Advisers Act Section 203A and Section II.B.1, supra.

92 NASAA reported that at least 47 states monitor compliance through examinations or audits of state-registered investment advisers. NASAA Report, supra note 405 in Section II.C.1 of the Study, at 7.

93 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 12.

94 Id.

95 Information in this chart is derived from the NASAA Report, supra note 405 in Section II.C.1 of the Study, at 21.

96 NASAA Report supra note 405 in Section II.C.1 of the Study, at 21.

97 Id. The NASAA Report did not identify the state.

98 Id.

years, an average of 203 examinations every year.[99] NASAA found that the vast majority (89%) of state routine examinations were completed on a formal cyclical basis, while a minority (11%) were performed on a random or ad hoc basis.[100] NASAA found that all states that adhered to a formal examination cycle audited their entire investment adviser registrant populations in six years or less.[101]

NASAA found that because the volume of data analyzed by state examiners during an examination was significant, the overall process was time-intensive. While the exact time it took to complete an examination depended upon the size and complexity of the firm being examined, NASAA reported that an average examination normally took two weeks, which included one to two full days on-site at the investment adviser's principal place of business.[102] NASAA also reported that states typically issued an audit report several weeks later that documented their findings.[103] NASAA stated that any examination that produced findings of fraud, abuse or other violations of the securities laws was quickly referred to state enforcement staff for further investigation and/or prosecution.[104]

C. Broker-Dealer Examinations

NASAA noted that state regulators implement a long-standing and uniform broker-dealer examination program encompassing the fifty states via routine examinations as well as risk-based selection methodologies.[105] NASAA found that these examinations, like those for investment advisers, are generally on-site, routine examinations, conducted periodically and on a "non-cause" basis.[106]

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99 Id.

100 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 8.

101 Id.

102 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 9.

103 Id.

104 Id.

105 Id.

106 NASAA stated that "because states are generally examining Broker-Dealer firms concurrent with FINRA and Commission examinations, state resources are often best spent on these risk-based exams."). NASAA Report, supra note 405 in Section II.C.1 of the Study, at 10.

The table below shows the number of broker-dealer examinations completed by the states since 2006.

Year	Broker-Dealer Examinations[107]
2010	1,525 (YTD – August 2010)
2009	1,774
2008	1,651
2007	1,537
2006	1,527

While many of these examinations are conducted within a state's routine audit cycle, NASAA reported that the states' broker-dealer examination program includes a "for-cause" component.[108] NASAA stated that in 34% of the states that conduct Broker-Dealer examinations, either most or all of such audits are "for cause."[109] NASAA also found that 46% the states conduct most or all of their broker-dealer examinations on a routine basis.[110] An additional 9% of states reported that their broker-dealer examinations are split evenly between routine and for-cause circumstances.[111] Regardless of the initial examination approach, NASAA stated that any broker-dealer examination that uncovers dishonest or unethical behavior, or fraud, was referred to enforcement staff for investigation and/or prosecution.[112]

D. Investment Adviser and Broker-Dealer Examination Outcomes

NASAA reported that states often issue a letter notifying a firm of the state's requirements and its failure to comply with them (a "deficiency letter").[113] NASAA found that virtually every state confirmed issuing deficiency letters, and in 2009 for

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107 Information in this chart is derived from the NASAA Report, supra note 405 in Section II.C.1 of the Study, at 22.

108 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 22. According to NASAA, states generally examine broker-dealer firms concurrent with FINRA and Commission examinations; therefore, NASAA believed that state resources are often best spent on these risk-based exams. NASAA noted that states also endeavor to reach small, remotely located offices where violations of the securities laws frequently occur. See NASAA Report at 10.

109 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 10.

110 Id.

111 Id.

112 Id.

113 NASAA Report, supra note 405 in Section II.C.1 of the Study, at 23.

instance, the states sent 5,176 deficiency letters as a result of their examinations.[114] NASAA reported that examinations will often trigger several deficiency letters, particularly if minor violations are sequentially discovered. A few states reported that 100% of their exams lead to a deficiency letter.[115] NASAA reported that most reporting states indicated that 100% of their deficiency letters resulted in satisfactory cures and compliance.[116] In 2009, state preregistration analysis or examination deficiency letters and resulting discussions with applicants or registrants led to 1,557 withdrawals of registrations.[117]

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[114] Id. The NASAA Report did not distinguish between actions taken with respect to investment advisers or with respect to broker-dealers (such as deficiency letters or revocations of registrations). Accordingly, the data in this section relates to both investment advisers and broker-dealers.

[115] Id.

[116] Id.

[117] Id.

Appendix B: Groups, Entities and Individuals Who Met with the Staff

- American Council of Life Insurers
- Ameriprise Financial
- Association for Advanced Life Underwriting
- Association of Institutional Investors
- Bond Dealers of America
- Charles Schwab
- Committee for the Fiduciary Standard, Professor Daylian Cain of the Yale School of Management, and Professor Tamar Frankel of the Boston University School of Law
- Consumer Federation of America and Fund Democracy
- Edward Jones
- Financial Planning Coalition
- Financial Services Institute
- FINRA
- Investment Adviser Association
- Morgan Stanley Smith Barney
- North American Securities Administration Association
- Primerica
- Public Investors Arbitration Bar Association
- Securities Industry and Financial Markets Association and Oliver Wyman
- State Farm
- TD Ameritrade
- TIAA-CREF
- UBS
- Wells Fargo Advisors